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## Shared Appreciation Mortgages

Ronald Friend

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# Shared Appreciation Mortgages

*By* RONALD FRIEND

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# Shared Appreciation Mortgages

By RONALD FRIEND\*

Various economic developments since 1972 have sharply limited affordable construction and permanent financing for commercial and other nonresidential properties, as well as for residential properties. As a result, the construction industry has suffered its most severe crisis in 35 years<sup>1</sup> due both to intense competition for diminishing capital and increased governmental restrictions on urban growth.<sup>2</sup> In the commercial sector, high interest rates have caused the failure of many construction projects and stopped countless others before they were started.<sup>3</sup> By the close of 1981, inflation, at an annual average rate of 13.04%,<sup>4</sup> and unprecedented volatility in interest rates,<sup>5</sup> had affected the housing market so severely that only 4.2% of American families could afford a \$60,000, thirty-year fully amortizing<sup>6</sup> loan at 16% interest.<sup>7</sup> The higher

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The author gratefully acknowledges the assistance in the preparation of this Article of his associate, Scott C. Verges, B.A., New College of the University of South Florida, 1977; J.D., University of California, 1980. Member, California and San Francisco Bars.

1. See generally Kuklin, *Real Estate Financing and The World We (Will) Live In*, 13 REAL PROP. PROB. & TR. J. 1116 (1978); *Housing's Storm*, BUS. WK., Sept. 7, 1981, at 60; McMahan, *The Future of the Real Estate Industry: Changing Supply Patterns*, REAL EST. REV., Spring 1977, at 68. One commentator noted: "In some areas, notably California, a layering of zoning and environmental commissions has evolved which now places the cost of the paperwork alone involved in obtaining the required development permits at \$5,000 per residential building lot." Strum, *Today's Real Estate Financing Climate—Some of the Causes and Some of the Problems*, 13 REAL PROP. PROB. & TR. J. 757, 760 (1978).

2. See *Housing's Storm*, *supra* note 1, at 63.

3. In the two-year period between 1978 and 1980, the decline in the number of building permits for apartment buildings was 20.57%; for office buildings, 14.40%; and for stores, 32.19%. See Construction & Building Products Division, Bureau of Industrial Economics, U.S. Dep't of Commerce, Table C-2—Private Residential and Nonresidential Buildings Authorized in 14,000 and 16,000 Permit-Issuing Places in the United States, CONSTRUCTION REV. 30 (Nov.-Dec. 1982).

4. See BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, CONSUMER PRICE INDEX FOR ALL URBAN CONSUMERS, U.S. CITY AVERAGE, ALL ITEMS (Jan. 1982) (average annual increase from 1972 through 1981 based on percentage of 1972 index).

5. The prime interest rate charged by nationally chartered banks increased from an average of 5.8% in 1972 to 20.5% in August 1981. The average interest rate charged by federal savings and loans for first mortgages during the same period increased from 7.38% to 17.33%. See Board of Governors of the Federal Reserve System, *Monetary Aggregates and Interest Rates; Prime Rate Charged by Banks*, FED. RES. BULL. (June 1973-1982).

6. A fully amortizing loan is "one where there are partial payments of the principal,

cost of financing, labor, and materials raised the median price of a new home from \$43,340 in 1976 to \$78,220 in 1981.<sup>8</sup>

Institutional lenders, holding many low-yield, fixed-interest-rate loans in their portfolios, underwent a similar economic squeeze.<sup>9</sup> During the periods of high inflation in the 1970's, deposits eroded drastically as depositors turned to higher yield investments.<sup>10</sup> To compensate, lenders were forced to borrow in the short-term market at substantially higher rates of interest.<sup>11</sup> This development further increased lending rates resulting in new borrowers subsidizing older mortgagors who benefited from pre-inflation costs.<sup>12</sup> By the close of 1975, long-term fully amortizing loans had become uneconomical, and lenders began offering various alternatives instead, including five-to-

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and accrued interest, at stated periods for a definite time, at the expiration of which the entire indebtedness will be extinguished." BLACK'S LAW DICTIONARY 108 (4th ed. 1957).

7. In a recent survey of 2,237 new home shoppers conducted by *Housing Magazine*, the maximum acceptable interest rate on a home loan was 13%. CAL. REAL EST., Feb. 1982, at 8.

The following table depicts the reduction of affordable housing resulting from increased lending rates:

Affordability of Housing  
Based on a 30-Year Term, \$60,000 Mortgage

Interest Rate	Monthly Payment	Annual Income Needed to Afford	Number of Families Who Can Afford	Percent of Families Who Can Afford
9	\$483	\$33,504	11,786,000	20.6%
10	527	35,626	10,328,000	18.4%
11	572	37,776	9,222,000	16.2%
12	617	39,936	7,896,000	13.6%
13	664	42,292	6,523,000	11.4%
14	711	44,448	5,207,000	9.3%
15	738	46,704	3,833,000	6.7%
16	807	49,056	2,402,000	4.2%

Reichelt, *SAMS: Recognizing Economic Reality*, MORTGAGE BANKING, July 1981, at 30, 37.

8. THE GUARANTOR, Jan.-Feb. 1982, at 14. A recent survey performed by the California Association of Realtors showed, as of November 1981, the median price of existing single-family homes in California was \$102,551. CAL. REAL EST., Feb. 1982, at 8.

9. See generally Cowan & Foley, *New Trends in Residential Mortgage Finance*, 13 REAL PROP. PROB. & TR. J. 1075 (1978); Iezman, *Alternative Mortgage Instruments: Their Effect on Residential Financing*, 10 REAL EST. L.J. 3 (1981) [hereinafter cited as Iezman, *Alternatives*].

10. See Cowan & Foley, *supra* note 9, at 1077.

11. "[T]he cost of funds . . . [is] the highest in more than 50 years . . . ." Boyle, *Dramatic Changes Likely in Real Estate Financing*, AM. BANKER, May 5, 1980, at 16.

12. See Iezman, *Alternatives*, *supra* note 9, at 4.

ten-year, interest-only, balloon-payment loans.<sup>13</sup> Federal and state governments, together with institutional lenders, promulgated a number of innovative lending practices. The most significant development was the emergence in 1977 of the so-called "creative financing" device, or alternative mortgage instrument ("AMI").<sup>14</sup>

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13. See Barton & Morrison, *Equity Participation Agreements Between Institutional Lenders and Real Estate Developers*, 12 ST. MARY'S L.J. 929, 932 (1981).

14. See generally FEDERAL HOME LOAN BANK BOARD, *THE ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY* (Kaplan ed. 1977). This study is published in three volumes and is an excellent source of statistical information concerning AMIs.

There are various AMIs presently available to home purchasers under both federal and California law. Although state law is generally more restrictive than federal law for comparable loans, it should be noted that the Garn Act, *see infra* text accompanying notes 217-20, creates a federal preemption whereby certain state lenders will be subject to only the more favorable of either federal or state restrictions on a particular loan. Some of these loan structures are:

A. Variable Rate Mortgage (VRM): CAL. CIV. CODE § 1916.5 (West Supp. 1982). The interest rate on a California VRM varies with a referenced index reflecting changes in the market interest rate. Although future monthly payments are unknown at the time the loan is originated, the VRM interest rate cannot increase more than 2.5 % over the life of the loan, with no increase greater than ¼% in any six-month period and no increase during the first six months of the loan.

B. Graduated Payment Mortgage (GPM): 12 C.F.R. § 545.6-4b (1982); Cal. Admin. Code tit. 10, R. 178.4(c) (1981). Under a GPM, the monthly payments start lower than comparable fixed-rate mortgages but rise later. The graduation rate, the term of graduation, and the interest rate are fixed for the life of the loan.

C. Reverse Annuity Mortgage (RAM): California savings and loan associations are allowed to offer RAM loans pursuant to the regulations promulgated in CAL. ADMIN. CODE tit. 10, R. 178.4(d) (1981). Federally chartered savings and loan associations offer RAMs under 12 C.F.R. § 545.6-4(c) (1982). In a rising-debt RAM the borrower receives monthly disbursements from the lender, gradually increasing the balance of the loan to a predetermined maximum. At the end of the term, the borrower can either sell the home or refinance it. A fixed debt with life annuity RAM calls for interest-only payments with the loan used to purchase a whole life annuity. From the annuity, the insurance company pays interest to the lender and the balance of the funds to the borrower. The balance is due on the earlier of the sale of the home or expiration of the term.

D. Pledged Account Loan (PAL): 12 C.F.R. § 545.6-2(a)(5) (1982). The PAL is a form of graduated payment mortgage. Early reduced loan payments result from supplements deducted from the homebuyer's initial down payment which is placed in an interest-bearing savings account. Each month a certain portion of those funds are withdrawn to supplement the monthly payment.

E. Renegotiable Rate Mortgage (RRM): CAL. CIV. CODE §§ 1916.8, 1916.9 (West Supp. 1982). The California RRM is a form of variable rate mortgage in which the interest rate cannot increase or decrease more than 5% over the life of the loan, with increases occurring no more than every three, four or five years. The maximum increase is ½% each year, multiplied by the number of years in the loan term up to the maximum permitted. RRM's can be long-term loans with periodic readjustments or short-term loans that can be automatically renewed. California RRM's are usually short-term loans secured by 30-year deeds of trust.

F. Adjustable Rate Loans (ARL): *Id.* § 1916.7 (West Supp. 1982); 12 C.F.R. § 545.6-4(a), (b) (1982). A California ARL must have a term of at least 29 years and must be amor-

AMIs, however, only served to compound the woes of the industry. Characterized by variable interest rates, short terms, and large balloon payments, AMIs, while a hedge against inflation for the lender, have only partially helped more families and businesses meet the financial qualifications for a real property secured loan.<sup>15</sup> Under the provisions of a standard adjustable rate mortgage, an annual income of \$30,800, 56% higher than the average American income, would be necessary for an 80% loan for the purchase of a median-priced home.<sup>16</sup>

Another financing technique appearing during the 1970's was the shared equity loan, or equity participation arrangement ("EPA"). Used primarily in commercial real estate settings,<sup>17</sup> an EPA creates a joint tenancy, tenancy-in-common, joint venture, or partnership arrangement between the "borrower" and the "lender."<sup>18</sup> The financing for the project is often provided without a fixed interest charge or other fixed return to the "lender," and the developer/owner is often permitted to take advantage of all the project's tax benefits. The financing party receives, in lieu of the traditional security device, an ownership interest in the project and is repaid when the project yields a net positive cash flow or when the property is sold. EPAs, however, have characteristics which some consider objectionable. In a commercial setting,

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tized over a period of not less than 30 years. The interest rate of a California ARL may increase no more than 7.5% annually and may be adjusted no more than two times per year. The federal regulations allow variable or adjustable rates without the restrictions of either the California ARL or VRM.

15. See Reichelt, *supra* note 7, at 33.

16. The above assumes a 16% per annum interest rate. See Iezman, *Shared Appreciation Mortgage*, L.A. LAW., May 1981, at 24 [hereinafter cited as Iezman, *Mortgage*]. Traditionally, homeowners devoted no more than 25% of their gross income to mortgage payments, including interest and taxes. It is not unusual now for a homeowner to devote 40% of his or her gross income to mortgage payments. Klamann, *The Short-Term Housing Outlook: Slow, Sluggish Growth*, AM. BANKER, Oct. 27, 1980, at 32.

17. See generally Barton & Morrison, *supra* note 13; Roegge, Talbot & Zinman, *Real Estate Equity Investments and The Institutional Lender: Nothing Ventured, Nothing Gained*, 39 FORDHAM L. REV. 579 (1971); Report of Subcommittee on Debtor-Creditor Problems of Real Estate Financing Committee, *Equity and Debt Participation—Possible Conflict of Duties*, 9 REAL PROP. PROB. & TR. J. 509 (1974); Comment, *Equity Participation In Texas: A Lender's Dream Or a Usurious Nightmare?*, 34 SW. L.J. 877 (1980).

18. One problem encountered when using EPAs is the uncertainty as to whether the transaction is a loan, a true equity participation (in which the financing party is a co-owner for all purposes), or a hybrid. Numerous authors commenting on EPAs have confused loan terminology and ownership terminology. E.g., Baker & Gianone, *Equities: An Alternative to the First Mortgage*, MORTGAGE BANKING, Nov. 1979, at 37. Barton & Morrison, *supra* note 13, at 933; Gallagher, *Computing the Lender's Yield on an Equity Participation Mortgage*, MORTGAGE BANKING, Feb. 1981, at 33, 37; Comment, *supra* note 17, at 879. One advantage of a shared appreciation mortgage (SAM) is that this confusion is avoided. See *infra* text accompanying notes 26-27, 281-88, 379-92.

many developers resented the limitations placed on their traditional independence by the management role that most financing parties required as an integral part of their equity participation.<sup>19</sup> In the residential market, the thought of owning a home as co-tenant with a bank did not appeal to many American homeowners.<sup>20</sup>

In 1980, institutional lenders, encouraged by proposed federal regulations,<sup>21</sup> began promoting yet another lending device, the shared appreciation mortgage ("SAM").<sup>22</sup> A typical SAM is a loan secured by a lien upon real property in which the currently payable interest rate is fixed below the prevailing market rate for a standard fixed-rate mortgage. In exchange, the lender receives, as "contingent deferred" interest, a predetermined share of the property's appreciation between the time the loan is made and the time the property is sold or the loan otherwise is paid. The appreciation portion of the interest is "contingent" because it is payable only to the extent the property appreciates in value. It is "deferred" because it is not payable until the maturity date of the loan or the sale of the property.<sup>23</sup>

SAMs offer a promising solution to many of the problems currently facing the real estate industry. Unlike traditional AMIs, SAMs allow moderate income households to qualify for larger loans by reducing the fixed monthly mortgage payments.<sup>24</sup> Developers or owners of commercial property enjoy similar benefits. SAMs also protect the

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19. See Barton & Morrison, *supra* note 13, at 933.

20. See The Washington Post, Sept. 12, 1981, at Real Estate, E55.

21. See Federal Home Loan Bank Board ("FHLBB") Resolution No. 80-610 (Sept. 30, 1980), 45 Fed. Reg. 66,801 (1980) (to be codified at 12 C.F.R. § 545.6-4(b)); see also text accompanying notes 217-29.

22. Wall St. J., Aug. 22, 1980, at 4, col. 2. Advance Mortgage Corporation, a subsidiary of Oppenheim & Co., appears to have been the first major promoter of SAMs. More than 100 SAMs were planned to be marketed by Advance Mortgage by the end of 1980. Coast Federal Savings & Loan Association in Sarasota, Florida, filled its \$2.5 million allotment with Advance Mortgage in three days. The remainder of Advance Mortgage Corp.'s first SAMs originated in Atlanta, Washington, D.C., Tempe, Phoenix, and Denver. Mylod, *Official Describes Experience with SAMs*, MORTGAGE BANKING, July 1981, at 12-13. Some institutional lenders were making SAMs or similar loans as early as 1969. See Reichelt, *supra* note 7, at 33.

23. There are a number of ways SAMs can be structured. For instance, many SAMs are 30-year loans with the lender receiving payment of principal and deferred contingent interest upon the sale of the secured property or maturity of the note. Other SAMs are short-term and subject to regular reappraisal and payment of contingent deferred interest. SAMs can be either amortizing or nonamortizing. The various SAMs, as well as many other AMIs, involve similar legal questions; the variations in form do not alter the legal implications.

24. See Iezman, *Mortgage*, *supra* note 16, at 24. The following table compares the payment and equity schedules of a fixed rate mortgage, VRM, GPM and SAM:



lender from unanticipated inflation.<sup>25</sup>

One important advantage of SAMs is that they are not limited to times of great inflationary expectations. Both the borrower and lender may find SAMs desirable when the inflationary outlook is mixed. The fluctuations in inflation during the past few years, for instance, have caused both borrower and lender to question the absolute inflexibility of long-term, fixed-rate mortgages. If rates go up, one party loses; if rates go down, the other loses. Allowing the lender to share in any appreciation of the mortgaged property, when combined with a fixed-rate interest element, provides much needed flexibility. Over the intermediate and long terms, interest and inflation rates will increase and decrease correlatively. A SAM allows the lender to protect itself

Type of Mortgage	Monthly Payment Average Interest Rate			Homeowner's Equity (Including Unrealized Appreciation)	
\$100,000 house					
\$ 80,000 loan	1-3 yrs.	4-5 yrs.	6-10 yrs.	5th yr.	10th yr.
Fixed Rate	\$948	\$948	\$ 948	\$82,306	\$183,147
	14%	14%	14%		
VRM	\$979	\$1,058	\$1,044	\$82,062	\$182,442
	14.5%	15.74%	15.5%		
GPM	\$795	\$951	\$1,060	\$73,034	\$174,171
	14%	14%	14%		
SAM	\$673	\$673	\$673	\$63,708	\$134,083
	9.5%	9.5%	9.5%		

Hayes, *Architects of Exotic Mortgages*, FORTUNE, Dec. 29, 1980, at 66, 68; see also *Commercial Mortgage Lenders Taking Hard Stance, Demanding More of the Action*, AM. BANKER, Oct. 3, 1980, at 8.

25. See FHLBB Resolution No. 80-610, *supra* note 21, at 66,802; Shared Appreciation Mortgage, 45 Fed. Reg. 66,802 (1980).

The following table shows the average rates of appreciation, by percentage in existing home prices, nationwide:

Three-year Period	Three-Year Moving Average Rates of Appreciation from 1970 through 1980				
	United States	Northeast	North Central	South	West
1970-1972	7%	8%	8%	9%	6%
1971-1973	8	9	8	9	8
1972-1974	9	10	8	10	10
1973-1975	10	10	8	10	12
1974-1976	10	8	9	8	14
1975-1977	10	7	10	7	18
1976-1978	11	7	12	9	19
1977-1979	14	9	13	12	19
1978-1980	12	10	12	13	16

Thygerson, *Pricing the SAM*, SAVINGS & LOAN NEWS, Dec. 1980, at 29.

against increases in interest rates, while allowing the borrower to provide that protection at the expense of a portion of the property's inflated value, all determined at the time of sale of the property. Conversely, if inflation and interest rates go down, the borrower benefits from the lower fixed-rate interest. Both borrowers and lenders may wish to use SAMs to balance variations in the interest and inflation rates occurring over the life of the loan.

SAMs, furthermore, do not create the uncertainty often associated with EPAs as to whether the transaction is a loan or an equity participation. As does a SAM, an EPA allows the financing party to base part or all of its return on the property's appreciation value. The EPA does this by making the financing party a co-owner rather than a lender.<sup>26</sup> Although the EPA achieves the financing party's goal of basing return upon appreciation, other unintended results sometimes follow because entirely different rights, benefits, and burdens attach where two parties are co-owners than attach where the relationship is that of lender and borrower. The financing party in an EPA may not wish to be bound by the rights, benefits, and burdens concomitant with co-ownership. In contrast, a SAM clearly defines the intended relationship as that of borrower and lender, thereby permitting the intended allocation of benefits and burdens.<sup>27</sup>

The advantages of SAMs over other so-called creative financing devices suggest that SAMs will play a major role in the real estate market in this decade.<sup>28</sup> Notwithstanding the apparent complexity of this new lending instrument, the initial offerings of residential SAMs have been exhausted within days.<sup>29</sup> Moreover, the Federal Home Loan Mortgage Corporation has adopted guidelines designed to encourage the purchase of SAMs on the secondary market.<sup>30</sup> More importantly, on August 23, 1982, the Federal Home Loan Bank Board ("FHLBB") promulgated final regulations permitting federal savings and loan associations to make SAMs.<sup>31</sup> As secondary markets adjust to the somewhat unusual characteristics of SAMs, and as the contours of these instruments become defined through legislative action, the demand for

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26. See *supra* text accompanying notes 17-20.

27. See CAL. CIV. CODE § 1917.160 (West Supp. 1982).

28. See *Two Equity Mortgage Plans Seek to Hold Down Housing Costs*, SAVINGS & LOAN NEWS, Oct. 1980, at 19.

29. See *supra* note 22.

30. See FEDERAL HOME LOAN MORTGAGE CORPORATION, *Shared Equity Plans*, SELLER'S GUIDE TO CONVENTIONAL MORTGAGES, at 122 (Change 21, Dec. 29, 1981).

31. 47 Fed. Reg. 36,612 (1982) (to be codified at 12 C.F.R. §§ 545.6-545.8-8). See *infra* text accompanying notes 217-29.

SAMs will increase.<sup>32</sup> The complexity of SAMs may result in their becoming a more popular tool in the commercial arena than in the residential.

After describing California statutory and nonstatutory SAMs, this Article will explore several legal and practical problems unique to this financing device and other AMIs. The legal problems include usury questions, the priority of liens against the property, and restraints on alienation, including due-on-sale clauses. This Article also discusses the potential for redlining, SAMs in relation to the Unruh Civil Rights Act, and possible tax implications. Finally, legal problems arising from SAMs as securities, partnership issues, and the potential for clogging the equity of redemption will be examined. The practical problems inherent in SAMs addressed by this Article include accounting for improvements made to the property, title insurance, security instruments, lender's problems and foreclosure. This Article concludes that both the legal and practical problems facing SAMs may be resolved under current precedents and that the numerous problems that some have felt SAMs and other AMIs create should not deter lenders from making such loans.

## The Statutory and Nonstatutory Shared Appreciation Mortgage

### California Statutory Shared Appreciation Mortgages

The first comprehensive statute regulating SAMs was signed into law by the Governor of California on October 1, 1981.<sup>33</sup> The Legislature adopted this statute in an effort to alleviate California's residential

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32. Cf. Reichelt, *supra* note 7, at 40.

33. Act of October 2, 1981, ch. 1144, 1981 Cal. Adv. Legis. Serv. 714 (Deering) (codified at CAL. CIV. CODE §§ 1917.110-1917.175 (West Supp. 1982)) (Assem. Bill No. 2168). Simultaneously, the California Legislature also passed the Act of October 2, 1981, ch. 1143, 1981 Cal. Adv. Legis. Serv. 702 (Deering) (codified at CAL. CIV. CODE §§ 1917.010-1917.075 (West Supp. 1982)) (Assem. Bill No. 2167), allowing a "comprehensive scheme" for providing SAMs by persons acting on behalf of pension funds subject to the Employee Retirement Income Security Act of 1974 (ERISA). Assembly Bill 2168 is more favorable to lenders. Among the important differences between the measures are: the permissible amortization rates, the initial permissible fixed interest rates, the refinancing which the lender must offer at maturity, and the manner in which property is appraised. Both Acts were repealed and replaced by the Act of July 9, 1982, Chapter 466. The July 9 act is identical to the repealed acts; its sole purpose was to move the acts to the correct division of the Civil Code. The ERISA SAM statute contains a "sunset" date of January 1, 1990, while the other SAM statute contains a "sunset" date of January 1, 1987. The sunset dates, often inserted in legislation creating new programs in order to encourage "aye" votes on the floor of the legislature, should not be construed as predicting a limited future for these "statutory" SAMs (as defined *infra* in note 36).

housing crisis by encouraging lenders to provide increased funding for SAMs.<sup>34</sup> Neither the federal government nor any other state legislatures have adopted comprehensive laws regulating or encouraging SAMs;<sup>35</sup> the California SAM statute will serve, therefore, as a model for future legislative action addressed toward SAMs.

Several characteristics distinguish the California statutory SAM.<sup>36</sup> First, the interest rate provision of a SAM is bifurcated; it consists of a fixed interest feature set below prevailing market rates<sup>37</sup> and a contingent deferred interest feature<sup>38</sup> established as a percentage of the net appreciated value<sup>39</sup> of the secured property as of the maturity date. The buyer must pay the contingent deferred interest upon the earliest of (1) the loan's maturity, (2) acceleration of the loan upon default, or (3) the sale or transfer of the secured property.<sup>40</sup> Second, in contrast to EPAs, the SAM lender does not become a co-owner, joint venturer or partner with the borrower. The parties are debtor and creditor, and a deed of trust or mortgage held by the lender secures the SAM.<sup>41</sup>

The third feature of the statutory SAM, one which safeguards the lender's contingent interest, requires that a SAM be paid in full upon the sale or transfer of the secured property.<sup>42</sup> The California SAM stat-

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34. CAL. CIV. CODE § 1917.110(a)-(c) (West Supp. 1982). *See generally* SENATE COMMITTEE ON BANKING AND COMMERCE, ANALYSIS OF AB 2168 (COSTA) AS AMENDED IN THE SENATE ON AUGUST 20, 1981, 1981-82 Reg. Sess. (hearing Aug. 26, 1981).

35. Only New Mexico, among the states, has considered legislation similar to the California SAM statute. The bill, N.M. S. 92, 35th Legis., 2d Sess. (1982), was defeated in the 1982 session of the New Mexico legislature. New FHLBB regulations, *see infra* text accompanying footnotes 217-229, impose a skeletal framework for SAMs at the federal level.

36. There are, essentially, two California SAM statutes. Civil Code §§ 1917.010-1917.075 enable pension funds to make SAMs. Civil Code §§ 1917.110-1917.175, the primary focus of this Article insofar as statutory SAMs are concerned, permit all "lenders" to make SAMs. SAMs created under §§ 1917.110-1917.175 are herein called "statutory SAMs." Lenders in California may also create SAMs which do not fit the SAM statute's definitions; such SAMs are herein defined as "nonstatutory SAMs." *See infra* note 67.

37. CAL. CIV. CODE § 1917.120 (West Supp. 1982). "Prevailing market rate" is defined in § 1917.120(g) as the "weighted average yield accepted by the Federal National Mortgage Association in its most recent free market system auction for four-month conventional mortgage commitments."

38. The contingent deferred interest portion serves a purpose similar to the "equity kicker" feature in loans in which the borrower must pay both monthly fixed interest and monthly contingent interest based on the operational net income of the borrower.

39. "Net appreciated value" is defined in § 1917.120(f) as "the fair market value less the sum of the borrower's cost of the property and the value of capital improvements." The provision also allows the borrower's selling costs as a deduction from fair market value in determining "net appreciated value."

40. CAL. CIV. CODE § 1917.131(e) (West Supp. 1982).

41. *Id.* §§ 1917.131(c), 1917.160 (West Supp. 1982).

42. *Id.* § 1917.162 (West Supp. 1982). A "sale" does not include a transfer specified in CAL. CIV. CODE § 2924.6 (transfers between spouses, transfers into an inter vivos trust, or

ute defines a "sale" as any transfer of title to the real property securing the loan, including refinancing, a trustee's sale, or a land sale contract giving the purchaser the right to possess the property before actual transfer of title.<sup>43</sup>

The fixed interest rate of a statutory SAM, and the extent of the lender's participation in the net appreciated value of the secured property, are determined by the ratio between the loan amount and the property's original value, and by a formula based upon a percentage of the prevailing market rate.<sup>44</sup> A lender's share in the property's net appreciated value cannot exceed 50%.<sup>45</sup>

Unlike traditional mortgages, SAMs must contain a method for

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transactions in which the secured property is made subject to a junior encumbrance or lien). *Id.* § 1917.120(i) (West Supp. 1982). See *infra* text accompanying notes 181-202.

43. CAL. CIV. CODE § 1917.120(i) (West Supp. 1982). Further, the California SAM statute provides: (a) the term of a statutory SAM must be at least seven but no more than 30 years; (b) the monthly installment payments must be such as would amortize the loan in not less than 30 nor more than 40 years; (c) the loan may be secured only by real property improved with one to four dwelling units, and (d) the loan must finance only owner-occupied dwelling units. To ensure the affordability of SAMs, the statute sets a ceiling on the amount lenders can charge borrowers as a loan fee. The limit is set at 2% of the principal amount of the loan or \$500, whichever is greater. In addition, the loan must be prepayable. *Id.* §§ 1917.130-1917.132 (West Supp. 1982). The prepayment provisions largely duplicate statutory provisions applicable to loans made by other than private lenders. *Id.* § 2954.9 (West Supp. 1982).

44. Civil Code § 1917.131(d) reads in part: "The percentage by which the fixed interest rate is reduced below the applicable prevailing rate shall be at least one-half the lender's percentage share of net appreciated value which is contingent deferred interest, except that if the shared appreciation loan is for less than 80 percent of the borrower's purchase price of the property, the percentage by which the fixed interest rate is reduced below the applicable prevailing rate shall be at least two-thirds the lender's percentage share of net appreciated value which is contingent deferred interest."

45. *Id.* § 1917.120(c) (West Supp. 1982); see also Thygerson, *Pricing The Shared Appreciation Loan Deserves Thought*, SAVINGS & LOAN NEWS, Nov. 1980, at 34. This Article contends that a lender's competitive pricing of SAMs depends upon four key variables:

- (1) The estimated rate of home appreciation;
- (2) The lender's share of home appreciation—the "appreciation kicker";
- (3) The downpayment; and
- (4) The term of the loan.

The following illustration provides a clear example of a statutory SAM:

*Assumptions:*

Cost or value of property	\$80,000
Amount financed (80%)	64,000
Prevailing market mortgage rate	15%
Deferred contingent interest (lender's share of net appreciated value of property)	50%
Fixed interest rate of SAM (reduction of one half of 50%, or 25%, below prevailing market rate)	11.25%
Level monthly payments (amortized 30 years)	\$622
Appreciation of property (compounded per annum)	8%

determining the property's fair market value when the loan matures. The California SAM statute provides four procedures for calculating fair market value: (1) a mutually agreed-upon value between borrower and lender;<sup>46</sup> (2) lender's stipulation of the minimum amount it considers to be the fair market value; if acceptable to the borrower, the stipulated figure remains firm for a maximum of 150 days;<sup>47</sup> (3) in the case of a cash sale where the borrower has not requested a stipulated minimum value, the gross sales price, if reflective of market value, determines the fair market value;<sup>48</sup> and (4) barring any agreement to the contrary, the fair market value must be determined by averaging two appraisals.<sup>49</sup> If the property is damaged beyond normal wear and tear and is not fully repaired, the fair market value is the value of the property assuming the repair has been made.<sup>50</sup> The borrower, therefore,

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*Settlement Statement After Five Years:*

Gross sale proceeds	\$117,546
Less Cost (assuming no capital improvements)	(80,000)
Appreciation	37,546
Lender's share of appreciation	18,773
Borrower's share of appreciation	18,773

Under this scenario, the lender's internal rate of return over the term of the loan is 15.24%.

46. CAL. CIV. CODE § 1917.142 (West Supp. 1982).

47. *Id.* § 1917.140 (West Supp. 1982).

48. *Id.* § 1917.141(a)-(d) (West Supp. 1982).

49. *Id.* § 1917.142 (West Supp. 1982) provides: "When Section 1917.141 requires the application of this section, the fair market value shall be determined as the average of two appraisals of the property performed as described in this section. If possible, the appraisals shall be based on the sale prices of comparable properties in the market area sold within the preceding three-month period. The appraisals shall be made upon request of the lender by two independent residential appraisers, one to be selected by the lender and one by the borrower. Each appraiser shall be approved by the Federal National Mortgage Association. The cost of the appraiser selected by the lender shall be borne by the lender, and the cost of the appraiser selected by the borrower shall be borne by the borrower, unless the average of the two appraisals equals or is less than the gross sale price of the property, in which case the lender shall also pay the fee of the borrower's appraiser up to two hundred dollars (\$200). If either of the appraisers determines that the gross sale price does not reasonably reflect the fair market value of the property, or, in the case of a sale for which appraisal is required by this section, then the fair market value of the property shall be determined as the average of the two appraisals. If the borrower fails to select a qualified appraiser within 15 days after the lender has notified the borrower in writing of the lender's request for an appraisal of the property, the reasons therefor, and the borrower's option to select an independent appraiser within 15 days after the lender's request is submitted to the borrower, the lender may designate the second appraiser, provided the lender's request informs the borrower of this time limitation, and that the lender will select an appraiser on behalf of the borrower in the event the borrower fails to designate an appraiser, with consequent cost to the borrower. If pursuant to this section the lender designates the second appraiser, the cost of both appraisals shall be borne equally by the borrower and lender."

50. *Id.* "If in any case the property has been damaged (other than normal wear and

cannot decrease the contingent deferred interest through its own waste.

The California SAM statute also addresses the problem of distributing the value of improvements made to the secured property during the term of the loan. Permanent improvements would be discouraged unless at least a portion of the improvement costs could be added to the original cost, or deducted from the sales price, before assessing the amount of contingent deferred interest payable to the lender. The California statute provides that, should the borrower make capital improvements in any twelve-month period that cost more than \$2,500, any resulting increase in the value of the property of \$2,500 or more can be added to the borrower's cost of the property in determining the net appreciated value.<sup>51</sup> However, if the borrower performs 50% or more of the value of the labor or other work on the improvement, only the value of the improvement, and not its cost, must exceed \$2,500.<sup>52</sup> The statute also contains provisions concerning the reporting of improvements and the method of reconciliation in the event of a dispute over the value.<sup>53</sup>

Another feature of the California statutory SAM protects the borrower from a forced sale in the case of a short-term loan. If a SAM with a term of less than ten years matures, the lender must offer or arrange refinancing of the remaining obligation.<sup>54</sup> When feasible, the

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tear) and the damage has not been fully repaired, the determination of fair market value shall be based on the condition of the property not including the damage."

51. *Id.* § 1917.150 (West Supp. 1982).

52. *Id.* § 1917.150(d).

53. *Id.* § 1917.150(a), (b). Subsection (b) provides: "If, within 30 days of receipt of the notice, the lender questions the claimed increase in value of the property by reason of the improvements, the lender and the borrower may, by mutual agreement, establish the value of the capital improvements or the lender may require appraisal of the property. An appraisal shall be made to determine the increase in value of the property, if any, by reason of the improvements, by two appraisers selected in the same manner specified in section 1917.142. If appraisals are performed, the increase in value resulting from the improvements for the purposes of this section, shall be one-half of the sum of the two appraisals. The cost of the appraiser selected by the borrower shall be borne by the borrower, and the cost of the appraiser selected by the lender shall be borne by the lender."

54. *See id.* § 1917.133(a) (West Supp. 1982): "The refinancing may be provided directly by the lender or another mortgage lender, or the lender may arrange at the time of making the shared appreciation loan for the refinancing to be provided by a federally or state chartered bank or savings and loan association doing business in this state or by a qualified mortgage banker. . . .

"If the original lender is a bank or savings and loan association doing business in this state or a qualified mortgage banker, it may provide the refinancing commitment to the borrower required by this section and assignees or successors in interest of the original lender shall not be guarantors of the refinancing obligation, provided the shared appreciation loan contains this limitation, which is fully and fairly disclosed to the borrower, and the original lender's refinancing commitment is fully enforceable by the borrower."

refinanced loan term must result in a repayment schedule based on a maturity date not less than thirty years from the date of the SAM's origination.<sup>55</sup> At the time of refinancing, the proceeds from the new loan would be used to satisfy the contingent deferred interest obligation, and the borrower would then occupy the same position as any other borrower under a deed of trust.<sup>56</sup>

The California legislature designed the SAM statute to facilitate the making of residential SAMs,<sup>57</sup> thereby "promot[ing] alternative means of supplying affordable housing."<sup>58</sup> To encourage SAMs, the statute offers several purported<sup>59</sup> benefits to SAM lenders who make loans conforming to it. First, the statute provides that SAMs with fixed interest rates below applicable California usury limits will not become usurious by reason of the contingent deferred interest element.<sup>60</sup> Second, the statute gives the lien of a SAM priority, even as to the contingent deferred interest, over any other lien or encumbrance recorded after the shared appreciation instrument.<sup>61</sup> Third, the California SAM

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55. *Id.* § 1917.133(b).

56. *See id.* § 1917.133(e).

57. Civil Code § 1917.163 (West Supp. 1982) provides: "This chapter facilitates the making of shared appreciation financing in this state which conforms to the provisions of this chapter." The statute, however, does not prohibit SAMs which do not conform to the statutory guidelines. *Id.*

58. *Id.* § 1917.110 (West Supp. 1982): "The Legislature hereby finds and declares that:

"(a) It is necessary and essential that the state provide and promote alternative means of supplying affordable housing to the citizens of the state.

"(b) Because of current economic conditions, including the unprecedented fluctuation in interest rates, alternative mortgage instruments must be developed to supplement the standard long-term, fixed-rate mortgage.

"(c) State facilitation of the shared appreciation loan will serve the need to develop alternative means of financing housing, particularly new homes, and will help to create vitally needed jobs in the construction industry."

While technically the California SAM statute applies only to SAMs meeting the definitional requirements of that statute, it is important to recognize that the California Legislature has found and declared that alternative mortgage instruments (including, e.g., both statutory and nonstatutory SAMs) "must be developed." *Id.* § 1917.110(b).

59. These benefits are described as "purported" because most or all of them would accrue to California SAMs that do not conform to the statutory definition, i.e., to nonstatutory SAMs. *See infra* text accompanying notes 68-74.

60. CAL. CIV. CODE § 1917.167 (West Supp. 1982): "A shared appreciation loan which at origination bears a fixed interest rate complying with the usury provisions of Article XV of the California Constitution shall not be deemed to become usurious by reason of the payment of contingent deferred interest pursuant to this Chapter."

61. *See id.* § 1917.166 (West Supp. 1982): "The lien of a shared appreciation loan, including the principal amount and all interest, whether accrued or to be accrued, and all amounts of contingent deferred interest, shall attach from the time of the recordation of the deed of trust securing the loan, and the lien, including the lien of the interest accrued or to be accrued and of the contingent deferred interest, shall have priority over any other lien or encumbrance affecting the property secured by the shared appreciation instrument, recorded



statute offers a legislative exemption from the possible effect of *Wellenkamp v. Bank of America*<sup>62</sup> and its progeny.<sup>63</sup> Fourth, the statute frees SAM interest rates from provisions of the Civil Code and the Financial Code regulating variable rate mortgages (VRMs) and renegotiable rate mortgages (RRMs).<sup>64</sup> Fifth, disclosures made pursuant to the SAM statute are the only state law disclosures required of SAM lenders.<sup>65</sup> Finally, the act purports to exempt at least some SAMs from the securities qualification requirements of the California Corporations Code.<sup>66</sup>

### Nonstatutory Shared Appreciation Mortgages

The California legislature intended the SAM statute to facilitate

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after the time of recordation of the shared appreciation instrument. However, nothing in this section or Section 1917.165 shall preclude a junior lien or encumbrance subordinate to the obligation of the shared appreciation loan. In no case may a junior lien achieve priority over the lien securing the obligation of the shared appreciation loan, provided that nothing in this section shall be construed to supersede Section 3134 of the Civil Code."

62. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

63. CAL. CIV. CODE § 1917.162 (West Supp. 1982): "(a) Notwithstanding Section 711, a provision in a shared appreciation loan made pursuant to this chapter permitting the lender to accelerate the maturity date of the principal and accrued interest on the loan upon sale of the property shall be valid and enforceable against the borrower, except as may be precluded by Section 2924.6.

"(b) The Legislature finds and declares that potential exposure to liability for enforcement of a 'due-on-sale' clause consistent with Section 711, as interpreted by the courts, makes use of such a provision impractical. Moreover, the additional risks to the lender inherent in shared appreciation financing are greater with longer loan terms (which are more desirable from the standpoint of housing affordability), but this risk is reduced with an enforceable 'due-on-sale' clause. Therefore, in order to facilitate shared appreciation financing, it is necessary to establish the exception specified in subdivision (a)."

64. See *id.* § 1917.164 (West Supp. 1982): "A shared appreciation loan shall not be subject to any provision of this code or the Financial Code which limits the interest rate or change of interest rate of variable interest rate or renegotiable interest instruments, or which requires particular language or provisions in security instruments securing variable or renegotiable rate obligations or in evidences of those debts.

This section is declaratory of existing law."

65. *Id.* § 1917.170(a) (West Supp. 1982): "(a) The disclosures made pursuant to this chapter, as required, shall be the only disclosures required to be made pursuant to state law for shared appreciation loans, notwithstanding any contrary provision applicable to loans not made under this chapter, except those, if any, that may be required by reason of the application of Division 1 (commencing with Section 25000) of the Corporations Code [relating to securities qualification requirements], or Chapter 2 (commencing with Section 11000) of Part 2 of Division 4 of the Business and Professions Code [Subdivided Lands Act] . . . ." This section does not exempt SAM lenders from the disclosure requirements of the Federal Truth-in-Lending Act.

66. See *id.* § 1917.168 (West Supp. 1982): "The qualification requirements of Sections 25110, 25120, and 25130 of the Corporations Code do not apply to a shared appreciation loan to the extent the exemption afforded by subdivision (p) of Section 25100 of that code is applicable."

and encourage residential SAMs. Nothing in the statute prohibits the making of a SAM that does not conform to it.<sup>67</sup> Additionally, upon close scrutiny, it appears that most, if not all, of the benefits purportedly bestowed on SAMs conforming to the statute are illusory in the sense that these benefits already exist for all SAMs.<sup>68</sup>

The first, second, and third benefits are discussed in detail in the next section of this Article examining legal questions.<sup>69</sup> The fourth benefit, exempting SAMs from laws regulating VRMs and RRM, merely restates existing law; the benefit is therefore available to non-statutory SAMs as well.<sup>70</sup> The fifth benefit, exempting SAMs from any other disclosure requirements of California law, apparently refers to the disclosure requirements imposed on VRMs and RRM.<sup>71</sup> However, the California SAM statute expressly states that, as a matter which is "declaratory of existing law,"<sup>72</sup> SAMs are not subject to statutes regulating VRMs and RRM; i.e., SAMs are deemed not to be either VRMs or RRM. Therefore, VRM and RRM disclosure requirements are not applicable to SAMs, whether or not they conform to the SAM statute. The last purported benefit tautologically states that statutory SAMs need not be qualified under the California Corporate Securities Law of 1968 "to the extent the exemption [of section 25100(p) of that law] is applicable."<sup>73</sup> Obviously, to the extent the exemption from qualification of the Corporate Securities Law is applicable to statutory SAMs, it is applicable to nonstatutory SAMs. The SAM statute's provision is meaningless because it purports neither to enlarge the exemption nor to state whether the exemption is or is not available for nonstatutory SAMs.<sup>74</sup>

A lender participating in a SAM, therefore, should consider one that does not fit the definitional requirements of a statutory SAM if a

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67. See *id.* § 1917.163 (West Supp. 1982): "The terms and conditions of any shared appreciation loan made pursuant to this chapter shall be consistent with this chapter. This chapter does not, however, apply to or limit shared appreciation financing of real property of a type specified in Section 1917.130 that is made pursuant to other provisions of law, or which is not otherwise unlawful. Nothing in this chapter shall be construed to in any way affect shared appreciation financing of commercial property or residential property not meeting the criteria specified in Section 1917.130."

68. See *infra* text accompanying notes 69-74.

69. See *infra* text accompanying notes 77-161, 181-202.

70. CAL. CIV. CODE § 1917.164 (West Supp. 1982), *quoted supra* note 64.

71. CAL. BUS. & TRANSP. AGENCY, DEP'T OF HOUSING & COMMUNITY DEVELOPMENT, ENROLLED BILL REPORT (AB 2168), 1981-82 Reg. Sess., at 2 (1981).

72. CAL. CIV. CODE § 1917.164 (West Supp. 1982), *quoted supra* note 64.

73. *Id.* § 1917.168 (West Supp. 1982), *quoted supra* note 66.

74. For a discussion of whether SAMs are subject to securities laws, see *infra* text accompanying notes 319-78.

nonstatutory SAM appears better suited to the needs of both borrower and lender.<sup>75</sup> A lender on nonresidential property is eligible only for nonstatutory SAMs. The various definitional requirements for a statutory SAM appear to be more the result of a legislature bound by traditional views of the appropriate terms for residential financing than of logical thinking.<sup>76</sup>

Statutory and nonstatutory SAMs offer solutions to many of the difficult lending problems facing lenders and borrowers. The relative complexity of this new lending instrument and its divergence from traditional lending forms, however, raise a number of legal questions. The California SAM statute resolves some of these issues for statutory SAMs, but leaves a number of questions unanswered as to both statutory and nonstatutory SAMs. Because SAMs are a versatile lending tool, the numerous legal questions relating to SAMs, whether statutory or nonstatutory, should be identified and examined before they ripen into litigation.

## Legal Questions

### Usury

One of the major benefits purportedly offered by the California SAM statute is protection from the usury laws. From biblical times, laws have prohibited usurious lending.<sup>77</sup> Although some states have no

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75. Although many variations of nonstatutory SAMs are possible, some variations benefitting the borrower, but not the lender, include eliminating the requirement that the loan amortize by providing for interest-only payments; eliminating any fixed term by providing that the loan would become due only upon some indefinite event such as the sale of the house, or, in the case of an employer/employee loan, upon termination of employment; placing a limit on the maximum amount of contingent deferred interest by providing that the fixed and the contingent interest portions, together, cannot exceed a fixed percentage per annum; providing that the fixed interest portion shall commence at a certain low rate and escalate each year, until reaching a limit; and extending the concept from residential to commercial property. *Cf.* CAL. CIV. CODE §§ 1917.120(j), 1917.130, 1917.131(a), (b) & 1917.131(d) (West Supp. 1982) (referring to California nonstatutory SAM provisions benefitting borrowers). Nonstatutory SAM provisions benefitting the lender, but not the borrower, include increasing the percentage of contingent deferred interest, eliminating the refinancing obligation, and permitting a shorter term. *Cf. Id.* §§ 1917.131(d), 1917.133, and 1917.131(a) (West Supp. 1982) (referring to California nonstatutory SAM provisions benefitting lenders). Anyone may be a lender or a borrower under a nonstatutory SAM.

76. For instance, the loan term of a statutory SAM may not exceed 30 years. *Id.* § 1917.131(a). It is impossible to imagine any borrower-protection or other public policy reason why statutory SAMs should be limited in such a fashion.

77. 25 *Leviticus* 35-38; *accord*, 22 *Exodus* 25; *cf.* 23 *Deuteronomy* 20 (King James) ("Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury."); Comment, *supra* note 17, at 877 n.5.

usury laws,<sup>78</sup> and others have such broad exemptions that few lenders would be concerned with potential usury problems,<sup>79</sup> numerous states still regulate the rate of interest that may be charged on at least some residential and commercial real property loans.<sup>80</sup> Consequently, commentators have questioned whether SAMs might violate the usury laws.<sup>81</sup> The amount of the contingent deferred interest paid under a SAM is based solely upon the appreciated value of the secured property. Normally, a SAM lender places no limit on the amount of contingent deferred interest that a borrower must pay. The absence of a limit enables the lender to maximize return and compensate for the possibility of slow appreciation of other SAMs it may hold. As a result, the amount of contingent deferred interest, when added to the fixed interest, may exceed any applicable usury limitations if the secured property significantly appreciates in value during the term of the loan.

Due to the great variation in usury laws among jurisdictions the SAM usury problem must be addressed on a state-by-state basis. There are, however, some general considerations applicable to all SAM lenders.

### *General Considerations*

If the lender or the SAM is not clearly exempt from an applicable usury law,<sup>82</sup> there are two general ways the usury issue may be resolved. Under the first method, the parties may stipulate in the SAM promissory note and deed of trust that the law of a more favorable jurisdiction will control. In most jurisdictions, however, the enforceability of this type of contractual provision will depend on factors relevant to a "governmental interests" analysis, which involves a determination of whether the selected jurisdiction has a legitimate interest in the application of its own law.<sup>83</sup> First, the choice of law provi-

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78. See, e.g., N.H. REV. STAT. ANN. ch. 336:1 (1966 & Supp. 1981).

79. See, e.g., FLA. STAT. § 687.03(1) (1966); ILL. ANN. STAT. ch. 74, § 4 (Smith-Hurd 1966); N.Y. GEN. OBLIG. LAW § 5-521 (McKinney 1978).

80. See, e.g., CAL. CONST. art. XV, § 1; TEX. CONST. art. 16, § 11; FLA. STAT. ch. 687 (1966 & Supp. 1982); N.Y. GEN. OBLIG. LAW § 5-501 (McKinney 1978 & Supp. 1981-1982).

81. See Iezman, *The Shared Appreciation Mortgage and the Shared Equity Program: A Comprehensive Examination of Equity Participation*, 16 REAL PROP. PROB. & TR. J. 510, 522 (1981) [hereinafter cited as Iezman, *Equity*]; Kmiec, *Shared Appreciation Mortgages: A Step Toward Making Housing a Bad Investment*, 10 REAL EST. L.J. 302 (1982); Comment, *supra* note 17.

82. E.g., see *infra* note 94.

83. See Preble & Herskowitz, *Recent Changes in California and Federal Usury Laws: New Opportunities for Real Estate and Commercial Loans?*, 13 LOY. L.A.L. REV. 1, 43-66 (1979); Werner, *Usury and The Variable-Rate Mortgage*, 5 REAL EST. L.J. 155, 156-57 (1976). The California requirements have been developed in the following opinions: Sarlot-

sion must not be a device designed solely to evade the usury laws.<sup>84</sup> Second, both parties must enter into the choice of law provision in good faith.<sup>85</sup> Finally, the chosen state must bear some relationship to the transaction.<sup>86</sup>

A second method of resolving the usury issue is to insert into the SAM promissory note a savings clause providing that the borrower's obligation to pay contingent deferred interest is limited to an amount<sup>87</sup> that, together with the fixed interest, will not exceed applicable usury limits. Two problems are, however, inherent in this method. It may not achieve the return on investment sought by many SAM lenders.<sup>88</sup> Further, courts have been willing to find loans usurious notwithstanding the insertion of a savings clause in the note.<sup>89</sup>

### *Contingency Rule*

The contingent deferred interest portion of a California statutory SAM cannot render an otherwise nonusurious loan usurious.<sup>90</sup> Non-conforming SAM lenders and nonstatutory SAMs, however, do not benefit from this statutory exemption.

A 1979 state constitutional amendment<sup>91</sup> changed the interest limitations of the California usury law; the maximum interest rate for loans

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Kantarjian v. First Pa. Mortgage Trust, 599 F.2d 915 (9th Cir. 1979); *Gamer v. duPont Glore Forgan, Inc.*, 65 Cal. App. 3d 280, 135 Cal. Rptr. 230 (1976); *Rochester Capital Leasing Corp. v. K & L Litho Corp.*, 13 Cal. App. 3d 697, 91 Cal. Rptr. 827 (1970); *Ury v. Jewelers Acceptance Corp.*, 227 Cal. App. 2d 11, 38 Cal. Rptr. 376 (1964).

84. *Werner, supra* note 83, at 156-57; *see also* *Fidelity Sav. Assoc. v. Shea*, 6 Idaho 405, 55 P. 1022 (1899).

85. *Fidelity Sav. Assoc. v. Shea*, 6 Idaho 405, 55 P. 1022 (1899).

86. *Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co.*, 642 F.2d 744 (5th Cir. 1981); *see also* *Hershman, Usury and the Tight Money Market—Revisited*, 24 BUS. LAW. 1121, 1135-37 (1969).

87. In calculating the maximum rate of return, there appear to be no California cases deciding whether lenders may take into account the fact that interest payments are not received currently but on a deferred basis. *Cf. Heald v. Friis-Hansen*, 52 Cal. 2d 834, 345 P.2d 457 (1959) (allowing compounding on an annual basis after default). In view of the time-value of money in today's economy, it seems clear that this is a relevant factor.

88. One reason lenders will make SAMs is to increase the number of borrowers qualifying for loans. Another is to achieve a potential yield on their loans higher than prevailing rates. In order to do this, the actual return on some SAM loans may need to exceed apparent usury limits to offset the lack of appreciation on properties subject to the lender's other SAM loans.

89. *E.g., Oklahoma Preferred Fin. & Loan Corp. v. Morrow*, 497 P.2d 221 (Okla. 1972); *Southwestern Inv. Co. v. Hockley County Seed & Delinting, Inc.*, 511 S.W.2d 724 (Tex. Civ. App. 1974).

90. *See supra* text accompanying note 60.

91. Assembly Constitutional Amendment No. 52 (1979 Cal. Stat. ch. 49) ("Proposition 2"), CAL. CONST. art. XV, § 1.

or forbearances for the purchase, construction or improvement of real property in California is now subject to a specified formula.<sup>92</sup> The law imposes severe sanctions for exceeding the applicable interest rate.<sup>93</sup>

The California usury limits do not apply to all lenders and all loans.<sup>94</sup> Indeed, the statutory exemptions currently available to lenders are so extensive that many nonstatutory SAMs will not be subject to any usury limits.<sup>95</sup> There will be, however, some SAM lenders that will not be exempt from California usury limits by virtue of the California SAM statute or other statutory or constitutional provisions.<sup>96</sup>

For SAM lenders not exempt by statute from the usury limits, a

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92. Proposition 2 established the maximum interest rate for loans for the purchase of real property as equal to "the higher of (a) 10 percent per annum or (b) 5 percent per annum plus the rate prevailing on the 25th day of the month preceding the earlier of (i) date of execution of the contract to make the loan or forbearance, or (ii) the date of making the loan or forbearance established by the Federal Reserve Bank of San Francisco on advances to member banks under Sections 13 and 13a of the Federal Reserve Act." The maximum is 10% for any loan or forbearance of any money, goods or things in action which are used primarily for personal, family or household purposes. However, any loan or forbearance, the proceeds of which are used primarily for the purchase, construction or improvement of real property, is deemed not used primarily for personal, family or household purposes. *Id.*

93. CAL. CIV. CODE § 1916-3(a), (b) (West Supp. 1979).

94. Many usury exemptions are available to SAM lenders. First, as discussed above, SAMs conforming to the California SAM statute are exempt from the California usury limit. *Id.* § 1917.162 (West Supp. 1982). Second, many institutional lenders are exempt from the California usury limit, including banks, credit unions, industrial loan companies, pawn brokers, and savings and loan associations. CAL. CONST. art. XV, § 1 (West Supp. 1982). California statutory law exempts out-of-state banks and national banks. CAL. FIN. CODE § 1716 (West Supp. 1982). As a result, there is no applicable usury limit for most institutional loans, whether made upon residential or commercial property. The foregoing exemptions do not protect noninstitutional lenders making nonstatutory SAMs. Many of these lenders, however, may be protected by the 1979 amendment which added an exemption for "any loans made or arranged by any person licensed as a real estate broker by the State of California and secured in whole or in part by liens on real property." CAL. CONST. art. XV, § 1 (West Supp. 1982).

The ambiguous term "arranged" has been subject to much scholarly scrutiny since 1979. *See, e.g.,* Preble & Herskowitz, *supra* note 83, at 22-29. The courts have distinguished "finders" from "brokers" suggesting that Proposition 2 does not permit exemptions for loans arranged by finders. *See, e.g.,* Tyrone v. Kelley, 9 Cal. 3d 1, 507 P.2d 65, 106 Cal. Rptr. 761 (1973); Zappas v. King Williams Press, Inc., 10 Cal. App. 3d 768, 89 Cal. Rptr. 307 (1970).

95. *See supra* note 94. In 1980, Congress adopted the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980). This Act preempts state usury limits for certain types of loans made by specified lenders. For instance, the Act preempts state usury ceilings on first mortgage loans secured by residential property if the loans are made by designated lenders. Various other exemptions in the Act affect a wider range of SAMs.

96. The above described exemptions, while broad, do not apply in all circumstances. Thus, for instance, a sale by an owner wishing to carry-back a SAM, a loan by a nonexempt institutional lender which is arranged by a finder (not a broker), or a loan by a nonexempt institution to an employee, is not exempt in California.

common law exemption known as the contingency rule should be applicable. The case of *Thomassen v. Carr*<sup>97</sup> sets forth the California version of the contingency rule. In this case, the court stated:

It is also a general principle that when payment of full legal interest is subject to a contingency so that the lender's profit is wholly or partially put in hazard the interest so contingently payable need not be limited to the legal rate, providing the parties are contracting in good faith and without the intent to avoid the statute against usury.<sup>98</sup>

Under the common law version of the contingency rule, a lender is exempt from usury laws only if the risk of not receiving the contingent interest payment is not "remote."<sup>99</sup> The California courts have followed this common law precedent, requiring that the contingency or risk to which the interest or portion thereof is subject be "over and above the risk which exists for all loans (whether the risk be great or small), that the borrower will be unable to pay."<sup>100</sup> The contingency must be such that there is a bona fide economic risk to the lender that the contingent interest will not become payable.<sup>101</sup>

Application of the contingency rule also necessitates determining whether the fixed interest portion of the loan assures the lender of a return close or equal to the usury limit. It is reasonable to assume that, where a lender charges both a fixed interest rate that is near to the usury limit and a contingent interest element, the policy justification for the contingency rule may not be present.<sup>102</sup> Often, however, SAMs will have either a fixed interest rate set materially below the prevailing usury limit or a fixed interest rate close to the usury limit which was set at a time when future appreciation appeared limited.

The most important consideration in applying the contingency rule to SAMs is whether the contingency constitutes a material bona fide risk. The first important source of law for consideration of this matter, relied on by several California courts,<sup>103</sup> is the Restatement of Contracts. Section 527 of the Restatement states that, except in cases of sham, a promise to pay a rate of interest exceeding the usury rate is not usurious if: (1) the promise is conditional; and (2) the rate to be paid

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97. 250 Cal. App. 2d 341, 58 Cal. Rptr. 297 (1967).

98. *Id.* at 346, 58 Cal. Rptr. at 301 (quoting *Lamb v. Herndon*, 97 Cal. App. 193, 201, 275 P. 503, 507 (1929)).

99. RESTATEMENT OF CONTRACTS § 527, comment a (1932), *quoted infra* note 105.

100. 250 Cal. App. 2d at 347, 58 Cal. Rptr. at 301.

101. *Teichner v. Klassman*, 240 Cal. App. 2d 514, 521-22, 49 Cal. Rptr. 742, 748 (1966).

102. *See id.* at 521, 49 Cal. Rptr. at 748.

103. *E.g., id.*; *Wooton v. Coerber*, 213 Cal. App. 2d 142, 148, 156, 28 Cal. Rptr. 635, 638, 643 (1963).

upon failure of the condition is "materially" less than the usury rate.<sup>104</sup> A comment to section 527 explains that a loan is presumably usurious if the possibility of occurrence of the contingency is "remote." Additionally, the interest rate diminution in the event of such failure must not be "slight."<sup>105</sup>

Four California cases deal with the contingency rule. *Jameson v. Warren*,<sup>106</sup> one of the oldest relevant cases, involved stock delivered to a lender as security for a note that provided for interest at eight percent per annum. In addition to receiving interest on the note, the lender was to retain the dividends from the stock. When the dividends paid were added to the interest received, the lender's total compensation exceeded the usury limit in effect at the time. Although the court acknowledged the existence of the contingency rule, it denied its applicability because the facts did not present the requisite risk. The court noted that the term of the loan was thirty days and the amount of dividends to be retained by the lender was "more than double the amount of the loan."<sup>107</sup> Further, the expected dividends not only were large, but were apparently rather certain inasmuch as they were not annual dividends but dividends upon dissolution of the corporation, the corporation then being in liquidation.<sup>108</sup>

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104. "A promise, made as the consideration for a loan or for extending the maturity of a pecuniary debt, to give the creditor a greater profit than the highest permissible rate of interest upon the occurrence of a condition, is not usurious if the repayment promised on failure of the condition to occur is materially less than the amount of the loan or debt with the highest permissible interest, unless a transaction is given this form as a colorable device to obtain a greater profit than is permissible. In that case it is usurious." RESTATEMENT OF CONTRACTS § 527 (1932).

105. "A creditor who takes the chance of losing all or part of the sum to which he would be entitled if he bargained for the return of his money with the highest permissible rate of interest is allowed to contract for greater profit. On the other hand it is not permissible to use this form of contract as a device for obtaining usurious profit. If the probability of the occurrence of the contingency on which diminished payment is promised is remote, or if the diminution should the contingency occur is slight as compared with the possible profit to be obtained if the contingency does not occur, the transaction is presumably usurious." *Id.*, comment a. Comment a to section 527 of the Restatement of Contracts is cited and quoted favorably in the recent California cases cited *supra* note 103. Directly relevant is illustration number three of section 527: "A borrows from B \$5000, payable in three years. It is provided in the bargain that instead of interest A shall pay B one tenth of the profits of A's business. Although it is anticipated that this will exceed the amount of interest at the highest permissible rate, the bargain is not usurious in view of the contingency that the anticipation may not be realized." *Id.*, illustration 3.

106. 91 Cal. App. 590, 267 P. 372 (1928).

107. *Id.* at 595. The unofficial reporter reads, "more than equal the amount of the loan." 267 P. at 374.

108. "In the present case, however, while the evidence respecting the condition of the corporation is not before us, it sufficiently appears from the record that large dividends upon



In *Schiff v. Pruitt*,<sup>109</sup> the plaintiff planned to construct numerous homes on a tract of land he already owned. The defendant made plaintiff a construction loan of \$20,000. The note stated that the only interest to be paid by plaintiff on the loan was five dollars. The note also provided, however, that in consideration for making the loan, defendant would have the right to purchase, at a price calculated by a predetermined formula set forth in the note, contracts of sale or purchase money deeds of trust received by plaintiff upon the sale of the first thirty houses erected. Evaluating the risk involved in this loan, the court noted that there was no guarantee that the amounts paid under the fixed formula would be any less than the value of the notes and contracts received. Accordingly, a loss rather than profit might have resulted.<sup>110</sup> On the basis of this factual situation, the court held that the usury limitations did not apply by virtue of the "clear" applicability of the contingency rule.<sup>111</sup>

The lender in *Teichner v. Klassman*<sup>112</sup> made a loan calling for interest in excess of the established usury rate. The loan proceeds were used to purchase a gambling club. Under the note, plaintiff's obligation to make payments ceased if the gambling club was permanently closed due to any change in the city, county, or state laws regarding gambling institutions. The court held that this promissory note did not satisfy the contingency rule for two reasons: first, the transaction was conceived and formulated with the express purpose and intent to evade the usury laws,<sup>113</sup> and second, the risk was not substantial enough to justify application of the contingency rule.<sup>114</sup>

*Thomassen v. Carr*<sup>115</sup> is most directly on point. In *Thomassen*, the plaintiff borrowed \$18,500 from defendant. The note representing the loan provided that the loan's term was eighteen months and that the loan was interest-free. In lieu of interest, the note provided that the

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the stock pledged were anticipated, and that under the terms of the agreement the lender — who was to be repaid the principal of his loan with interest in any event — was entitled to retain from such dividends more than double the amount of the loan, if the latter should not be repaid in fifteen days. We think it is sufficiently shown by the terms of the contract that it was the intention of the parties to violate the usury law; and that the effect of their agreement, in view of what fairly appears to have been the condition of the corporation within their knowledge, was to exact for the use of the amount of the loan sums in excess of the lawful rate of interest." *Id.* at 595-96, 267 P. at 374.

109. 144 Cal. App. 2d 493, 301 P.2d 446 (1956).

110. *Id.* at 498, 301 P.2d at 449.

111. *Id.* at 499, 301 P.2d at 450.

112. 240 Cal. App. 2d 514, 49 Cal. Rptr. 742 (1966).

113. *Id.* at 522, 49 Cal. Rptr. at 749.

114. *Id.* at 522-23, 49 Cal. Rptr. at 749.

115. 250 Cal. App. 2d 341, 58 Cal. Rptr. 297 (1967).

lender would receive 30% of the borrower's net profit, if any, on the sale of the secured property. The court held that this note did not violate the California usury laws because "[o]n the face of the transaction in this case, it appears, as the trial court found, that the special hazard exists,"<sup>116</sup> because the risk that there would be no profits was a risk "over and above the risk which exists for all loans . . . that the borrower will be unable to pay."<sup>117</sup>

In discussing the substantiality of the risk, the *Thomassen* court addressed plaintiff's argument that the contingency that the interest payment would be lost was so remote that the transaction was usurious as a matter of law. In rejecting this contention, the court placed much reliance on the testimony of an appraiser, and noted that "there is a gamble to such a transaction as this; that construction of an office building in San Jose was a somewhat speculative investment; that his appraisal was made after he had information as to the actual rental and that this was a factor in the appraisal."<sup>118</sup> The court also cited the appraiser's conclusion that the value of the property was dependent upon "the highly fortuitous element of the time and terms at which rental could be accomplished."<sup>119</sup>

These cases illustrate risks that may, or may not, justify application of the contingency rule. In the two cases most analogous to SAMs, the contingency rule was applied. Although these cases demonstrate that the application of the contingency rule is, predominantly, a factual question, the *Thomassen* and *Schiff* holdings demonstrate a likelihood that the contingency rule will apply to SAMs unless the fixed interest rate is too close to the usury limit or unless some peculiar circumstances are present.

The *Jameson* and *Teichner* courts held that the risk in each case was insufficient to justify application of the contingency rule.<sup>120</sup> Neither case, however, is factually analogous to a SAM. Moreover, the

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116. *Id.* at 347, 58 Cal. Rptr. at 301.

117. *Id.* The special hazard existed because, "although by the terms of the promissory note the makers bind themselves unconditionally to repay the principal and interest at the end of 18 months, they are not obliged to pay interest for the first 18 months, but only to pay a share of the profit if there be any, and a share of rental if there be rental. The lenders' 'profit' was not only subject, as in loans generally, to the risk of inability of the debtors to pay, but to extinction by eventualities in this single transaction even though the debtors were at all times solvent." *Id.* at 347, 58 Cal. Rptr. at 301.

118. *Id.* at 348, 58 Cal. Rptr. at 302.

119. *Id.*

120. 91 Cal. App. at 595-96, 267 P. at 374; 240 Cal. App. 2d at 522-23, 49 Cal. Rptr. at 749.

risks in both cases of not receiving interest in an amount less than the usury limits were substantially less than in a SAM.

For instance, in *Jameson* there existed an extremely slight risk that the lender would not receive interest payments in excess of the usury limits.<sup>121</sup> First, the fixed interest rate was close to the usury limits, and second, the contingency was unlikely to occur. The facts in *Jameson*, particularly the thirty-day term of the loan, support the court's apparent conclusion that the dividend scheme was fabricated in the hope of avoiding the usury law, with neither party having any real belief that the "contingency" was actually contingent.

In contrast, the likelihood of property values appreciating under a SAM is independent of any forces such as regular corporate practice, shareholder expectations, or board policy. Rather, property value appreciation is wholly dependent upon economic conditions. Further, the corporate dividend policy in *Jameson* was, in view of the then pending corporate liquidation, relatively certain. Conversely, even in the most inflationary times there is a substantial possibility of downturns, temporary or long-term, local or broad-scale, in property values.

The risk that the lender in *Teichner* would receive interest payments in an amount exceeding the usury limits was also much greater than with a SAM. There, the lender was entitled to usurious interest unless existing circumstances (i.e., the right to conduct a gambling business) changed.<sup>122</sup> As in *Jameson*, the *Teichner* court found no evidence that the risks of the purported contingency were real. In addition, the court concluded that the terms of the loan were formulated in an effort to evade the usury laws.

In both *Schiff* and *Thomassen*, the risks to the lenders were analogous to the risks a SAM lender incurs in charging contingent deferred interest. In both cases, the lenders' yield on the transaction depended upon the appreciation of the value of real property. Moreover, both lenders had no particular reason to believe that the property values would necessarily appreciate. On this basis, the courts held that the financing arrangements were subject to a bona fide economic risk justifying application of the contingency rule.<sup>123</sup>

The SAM financing device is, however, somewhat distinguishable from these two cases. In both *Thomassen* and *Schiff*, the lenders risked losing all return of interest on their loans if the real property did not

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121. 91 Cal. App. at 595-96, 267 P. at 374.

122. 240 Cal. App. 2d at 517, 49 Cal. Rptr. at 746.

123. 144 Cal. App. 2d at 498-99, 301 P.2d at 449-50; 250 Cal. App. 2d at 349, 58 Cal. Rptr. at 302.

appreciate in value.<sup>124</sup> Because a SAM lender also charges a fixed interest rate, it does not risk a complete loss of interest payments. Nevertheless, the return of contingent deferred interest represents a significant portion of the lender's expected yield. Further, the Restatement of Contracts expressly contemplates that a contingency may relate to only a portion of the interest.<sup>125</sup> Finally, *Thomassen* expressly stated in dicta that the contingency rule could apply where only a portion of the interest obligation was at risk.<sup>126</sup>

### *Usury Conclusion*

The *Thomassen* and *Schiff* courts contemplated that the economic risk extend to the "contingent" interest up to the usury limit, as well as to that which might be above the usury limit.<sup>127</sup> The lender must bear a bona fide economic risk as to a portion of contingent interest which, if lost, would place the amount of interest received materially below the amount of interest which it might have charged on a flat-rate, non-contingent loan at the usury limit. Moreover, both courts carefully considered whether the anticipated appreciation of the properties did constitute a risk.

Statistics and assumptions about real estate values in the general area, or for the particular property, are very relevant in determining whether a particular loan presents a bona fide contingency; such considerations, however, may not be conclusive. The lender should also decide for each SAM whether the fixed rate is materially below the usury limit, and whether the contingent interest on the particular loan presents an actual contingency.

These issues involve complex factual judgments subject to judicial scrutiny in the event of litigation. It appears, however, that the contingency of appreciation in value of any particular parcel of real estate sufficiently justifies application of the contingency rule to any SAM not involving an extraordinary factual situation.

### **Lien Priorities**

SAMs, as well as other AMIs, raise a question concerning lien pri-

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124. 144 Cal. App. 2d at 498, 301 P.2d at 449; 250 Cal. App. 2d at 348-49, 58 Cal. Rptr. at 302.

125. RESTATEMENT OF CONTRACTS § 527 comment a (1932), *quoted supra* note 105.

126. 250 Cal. App. 2d at 346, 58 Cal. Rptr. at 301. *See supra* text accompanying note 98.

127. 144 Cal. App. 2d at 499, 301 P.2d at 450; 250 Cal. App. 2d at 349, 58 Cal. Rptr. at 302.

orities.<sup>128</sup> Simply put, does a lien attaching to the property after recording of a SAM have priority over the SAM lien to the extent of the latter's contingent deferred interest? The issue is critical because the contingent deferred interest element represents a substantial portion of a SAM lender's potential return.

To illustrate, assume a lender loans \$100,000 for the purchase of a \$150,000 house and secures the loan by a SAM in which the lender obtains a 50% interest in the appreciated value of the property. Further, assume that shortly thereafter the owner obtains a \$30,000 loan secured by a standard form second deed of trust. If the owner defaults on the fixed interest obligation of the SAM loan after the property has appreciated in value to \$200,000, the junior lienholder may assert that its lien is subordinate only to the unpaid principal balance of the SAM, and is not subordinate to the SAM lender's interest in the \$50,000 appreciated value because the appreciation occurred after the second lien attached.<sup>129</sup> Among other things, that would require the senior lender to pay off the junior lender before the senior lender could credit bid the amount of its contingent deferred interest at its foreclosure sale.

The California SAM statute specifically addresses this question, providing that the SAM lien has priority from the time of recording for principal and accrued and unaccrued interest, including contingent deferred interest.<sup>130</sup> However, nonstatutory SAMs are not protected by this provision. Instead, lenders making nonstatutory SAMs must rely on other principles of law to determine the priority of their liens.

There is no analytical basis for suspecting that a lien securing future accruing contingent interest should not be prior to subsequent liens. No authority has been found suggesting that the lien of an ordinary deed of trust does not secure fixed interest accruing in the future with the same priority as the principal obligation, despite the fact that standard forms of deed of trust and mortgage disclose neither the rate of interest nor whether the interest accrues or is payable currently.<sup>131</sup> Nothing inherent in a SAM should cause it to be treated differently.

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128. Two commentators have specifically addressed this question in connection with AMIs. See Barnett, *Alternative Mortgage Instruments: How to Maintain Secured Lender Status*, 96 BANKING L.J. 6, 45 (1979); Guttman, *Types of Adjustable Rate Mortgages and Their Lien Priority*, 55 FLA. B.J. 552 (1981).

129. For purposes of the discussion the illustration assumes that the second lien was placed on the property prior to the time the amount of appreciation is determined, see *infra* text accompanying notes 472-75, and prior to the time any of the appreciation in fact occurred, a "worst case" scenario insofar as the first lender's priority is concerned.

130. See *supra* note 61.

131. E.g., CAL. CIV. CODE § 2948 (West 1974).

For lien priority purposes, contingent deferred interest under a SAM is indistinguishable from interest under a traditional loan. That the interest accrues in the future—after both the SAM and the junior lien are recorded—does not distinguish a SAM from a typical deed of trust. Further, compounding of the deferred interest does not distinguish a SAM from a standard loan providing for compounding of interest; the contingent interest differs only in amount, not in legal principle. Similarly, deferral of payment is of no consequence. A standard lender, who for whatever reason delays foreclosure for two years while monthly installments become delinquent, does not thereby lose its priority as to the accrued but unpaid interest, even though the deferral may have resulted from the lender's voluntary course of action. The same is true in the case of a loan which provides that all interest and principal will be paid at the end of, e.g., five years. Similarly, the contingent nature of the interest is irrelevant. It is contingent only in the sense that the dollar amount is unascertainable when the loan is made; no one has seriously suggested that a standard loan carrying interest at the prime rate, which varies periodically, has any lien priority problems.

In short, the lien priority question raised by some commentators<sup>132</sup> for AMIs and SAMs seems merely the product of overactive imagination. The only analogous cases found in which priority has been questioned involve situations where the borrower and the lender voluntarily altered the secured obligation after the junior lien was made.<sup>133</sup> Obviously, once a junior loan is made, a SAM holder cannot be allowed thereafter to erode voluntarily the junior creditor's lien. However, no lien priority problem exists where the SAM borrower's obligations, though both unaccrued and unascertainable, are nevertheless fixed as of the date the junior loan is made.

### *Priority of Alternative Mortgage Instruments*

The standard adjustable rate mortgage and variable rate mortgage<sup>134</sup> instruments provide that the borrower may defer interest payments resulting from increases in the interest rate until maturity. If the borrower elects to defer such payments, the balance that the borrower must pay upon maturity may substantially exceed the original principal

132. *E.g.*, Murray, *Title Insurance and the Equity Kicker*, NAT'L L.J., Nov. 9, 1981, at 21, 24.

133. *E.g.*, Keese v. Beardsley, 190 Cal. 465, 213 P. 500 (1923).

134. *See supra* note 14.

amount.<sup>135</sup> This situation is commonly referred to as "negative amortization." Thus, if the AMI lien did not secure future accruing interest as of the date of recordation of the AMI, a junior lienor would achieve priority over a portion of the debtor's ultimate obligation under the AMI.

No California cases discuss the priority of an AMI lien.<sup>136</sup> The commentators on this point generally agree, however, that, at least if sufficient notice of the variable interest element of the loan is given, the priority of the entire obligation will be assured.<sup>137</sup>

The potential negative amortization in some AMIs is similar to the contingent deferred interest in SAMs; similar reasoning, therefore, should apply. Adequate disclosure should be sufficient to put junior lienors on notice, thereby assuring the priority of the variable interest mortgage. If disclosure is sufficient, a junior lienor may be able to make a rough estimate of the potential growth in the senior lien. In any event, the junior lienor, when making its loan, will be on notice that its security position may be eroded by growth of the senior lien. A junior lienor with actual notice of a SAM lender's interest in the appreciation of the secured property will be able to consider this element in calculating the value of the property to be secured by the junior lien.<sup>138</sup>

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135. Presently, many title insurers will not insure the priority of a negative amortization loan. Efforts have been made, however, to develop a special endorsement for negative amortization loans, which now may be available from some title companies.

136. There are several recent articles discussing this problem. See Barnett, *supra* note 128; Iezman, *Equity*, *supra* note 81, at 521; Murray, *supra* note 132.

137. Generally, the commentators have concluded that the lien of an adjustable rate mortgage or variable interest rate loan will have priority over subsequent liens only if the notice to third parties is sufficient to put them on inquiry. One commentator stated: "An increase in interest on a loan might present a problem as to where it should be placed in the order of lien priorities. Most indications are that the lien priorities should not change if full disclosure occurs. This is logical because, if subsequent creditors are aware of the clause, they have no basis to contest an increase in interest on an existing loan as changing any priority." Comment, *The Variable Interest Rate Clause and Its Use in California Real Estate Transactions*, 19 U.C.L.A. L. REV. 468, 485 (1972) (footnote omitted). A recent article stated: "The minimum efforts which may protect the priority of an adjustable rate mortgage, including the interest as adjusted, would then appear to include the recording of the mortgage stating the principal debt secured and that the debt bears interest which is adjusted periodically according to the terms of the note." Guttman, *supra* note 128, at 555. This commentator adds, however, that it may be prudent to include a more thorough disclosure in which, "[t]he principal is identified, [as are the] adjustment period, initial rate of interest and the index which controls the movement." *Id.* at 556.

138. For a discussion of the degree or extent of notice, if any, which must be provided see *infra* text accompanying notes 149-61.

*Treatment as Interest*

In analyzing the lien priority of a SAM, contingent deferred interest may be analogized either to a borrower's obligation to repay fixed interest on a loan or to a borrower's obligation to repay a mandatory future advance.<sup>139</sup> Under either classification, the lien of this portion of the SAM will have priority over subsequent liens.

In a standard loan transaction the borrower is obligated to repay both the principal portion of the debt and all accrued interest. Normally, when the mortgage securing such a debt is recorded, no interest has yet accrued. Neither courts nor commentators have doubted, however, that the priority of the lien securing all subsequently accruing interest dates back to the time the mortgage was recorded.

This tacit understanding flows from three sources. First, it is a general principle of real property law that liens securing promissory notes attach to both the principal and interest portions of the debt. Courts have permitted lenders to begin foreclosure proceedings when a borrower has failed to make required interest payments.<sup>140</sup> Second, California Code of Civil Procedure section 728 permits beneficiaries under deeds of trust to begin foreclosure proceedings as to a portion of the secured property if interest payments are delinquent.<sup>141</sup> Neither of these situations has raised any question concerning the priority of the lien attaching to interest. Third, California Civil Code section 2844 provides that a lien may be created which takes effect immediately and which secures obligations not yet in existence.<sup>142</sup> As a result, such a lien "is not dependent for its existence upon subsequent acts requisite to its enforcement. When these acts are performed, they, by relation,

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139. A mandatory future advance is a fixed obligation imposed on a lender pursuant to the terms of a loan agreement or promissory note to make an additional advance to the borrower at some time in the future, usually after the borrower has satisfied certain specific conditions precedent.

140. "In a word, the interest is part of the *substance* of the mortgage-debt. It belongs not to it by *tacking* — it is not an *incident* of the debt, but *pro tanto*, it is the debt itself." *West Branch Bank v. Chester*, 11 Pa. 282, 290, 51 Am. Dec. 547 (1849) (quoting and affirming the lower court opinion) (emphasis in original); *see also* *Yoakam v. White*, 97 Cal. 286, 32 P. 238 (1893). *But see* *Van Loo v. Van Aken*, 104 Cal. 269, 37 P. 925 (1894).

141. "If the debt for which the mortgage, lien, or incumbrance is held is not all due, so soon as sufficient of the property has been sold to pay the amount due, with costs, the sale must cease; and afterwards, as often as more becomes due, *for principal or interest*, the Court may, on motion, order more to be sold. . . ." CAL. CODE CIV. PROC. § 728 (West 1980 & Supp. 1982) (emphasis added); *see* *Chinn v. Penn*, 179 Cal. 153, 175 P. 687 (1918); *Byrne v. Hoag*, 116 Cal. 1, 47 P. 775 (1897); *Yoakam v. White*, 97 Cal. 286, 32 P. 238 (1893).

142. "A lien may be created by contract, to take immediate effect, as security for the performance of obligations not then in existence." CAL. CIV. CODE § 2884 (West 1974).



become part of the established lien and are secured thereby."<sup>143</sup>

A borrower's obligation to pay interest in a traditional loan does not differ from a SAM borrower's obligation to pay contingent deferred interest. In both situations, when the lien is recorded, there is no accrued interest and therefore no obligation to pay.<sup>144</sup> Moreover, in both situations the loan can be structured so that no payment of interest is required until the note matures. Finally, it has not been suggested that a traditional loan with a variable interest rate raises priority problems. For years the loan industry assumed correctly that loans carrying a floating, unfixed (that is, unknown at loan inception) interest rate have no priority problems. From a junior lienor's perspective, such a loan is as uncertain in amount as a SAM. Particularly when most current loans now carry anything but standard, fixed-rate interest, a SAM should have no less priority.<sup>145</sup> The appreciated portion of a SAM debt being nothing more than deferred interest, mere notice in the deed of trust that it secures interest as well as principal should be sufficient to assure the priority of a SAM lien.

#### *Analogy to Future Advances*

Should a court decline to treat contingent deferred interest as interest, then certainly that court should treat the contingent payment as it would a future advance. Accordingly, if the SAM documentation satisfies the priority requirements of a future advance, the SAM lien for the contingent deferred interest should have full priority.

The priority of a lien for a future advance depends upon two factors: (1) whether junior lienors are given adequate notice of the future advance; and (2) whether the future advance is optional or obligatory.<sup>146</sup> Absent notice to the junior lienors that a particular lien secures both a present obligation and future advances, the lien for future advances will be junior to any intervening liens.<sup>147</sup> However, the notice may be either in the form of a statement that future advances will be

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143. *City of Santa Monica v. Los Angeles County*, 15 Cal. App. 710, 712, 115 P. 945, 946 (1911). See also *infra* note 158 & accompanying text.

144. See CAL. CIV. CODE § 2884 (West 1974), quoted *supra* note 142.

145. One should not be overly concerned about junior lienors suddenly finding themselves junior to, for example, \$50,000 of contingent deferred interest. It is standard practice for a junior lienor, before its loan is made, to obtain a statutory statement of loan condition which would disclose the SAM nature of the senior lien. See *id.* § 2943 (West 1974).

146. *Oaks v. Weingartner*, 105 Cal. App. 2d 598, 234 P.2d 194 (1951); *Lanz v. First Mortgage Corp.*, 121 Cal. App. 587, 9 P.2d 316 (1932).

147. See *Lumber & Builders Supply Co. v. Ritz*, 134 Cal. App. 607, 25 P.2d 1002 (1933); *Machado v. Bank of Italy*, 67 Cal. App. 769, 228 P. 369 (1924); *Atkinson v. Foote*, 44 Cal. App. 149, 186 P. 831 (1919).

secured, without any indication of the dollar amount, or by stating that a particular dollar amount is secured, and thereafter making advances up to that amount. The court in *Tapia v. Demartini* held that either method "is sufficiently definite to put subsequent encumbrancers on inquiry, and they must ascertain the extent of the lien, or suffer the consequences."<sup>148</sup>

However, extensive disclosures are not necessary to ensure adequate notice of future advances.<sup>149</sup> Although certain jurisdictions require lenders to specify the amount of future advances in the mortgage instrument,<sup>150</sup> California has no such requirement.<sup>151</sup> Indeed, the California Supreme Court has stated that a mortgage for future advances that gives notice to subsequent encumbrancers of its nature creates, without more, and in particular without any indication of dollar amount, a valid lien for all sums advanced.<sup>152</sup> In *Frank H. Buck Co., v. Buck*,<sup>153</sup> the court noted:

[I]n the absence of statutes providing otherwise a definite statement of amount is unnecessary and . . . all that can be required is that a mortgage designed to secure such future liabilities should describe the nature and amount of them with reasonable certainty, so that they may be ascertained by the exercise of ordinary diligence on proper inquiry.<sup>154</sup>

Thus, if a SAM deed of trust divulges that it secures a loan which includes a contingent deferred interest element, recitation of the terms of the loan should be unnecessary.

Notwithstanding the adequacy of notice, the lien priority of a future advance will not necessarily relate back to the initial lien unless the future advance is obligatory.<sup>155</sup> If the future advance is optional, its lien priority will be lost if the first lienor has actual notice of the subsequent lienor before making the future advance.<sup>156</sup> Thus, because actual notice is a factual issue that might be contested, the contingent

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148. 77 Cal. 383, 387, 19 P. 641, 643 (1888).

149. See *Lumber & Builders Supply Co. v. Ritz*, 134 Cal. App. 607, 25 P.2d 1002 (1933).

150. Barnett, *supra* note 128, at 15 n.31.

151. See, e.g., *Tapia v. Demartini*, 77 Cal. 383, 19 P. 641.

152. *Id.* at 387, 19 P. at 643; see also *Oaks v. Weingartner*, 105 Cal. App. 2d 598, 234 P.2d 194 (1951).

153. 162 Cal. 300, 122 P. 466 (1912).

154. *Id.* at 306, 122 P. at 468.

155. *Lumber & Builders Supply Co. v. Ritz*, 134 Cal. App. at 610, 25 P.2d at 1003.

156. See *Althouse v. Provident Mut. Bldg.-Loan Assoc.*, 59 Cal. App. 31, 38-39, 209 P. 1018, 1022 (1922); see also *Garcia v. Atmajian*, 113 Cal. App. 3d 516, 520, 169 Cal. Rptr. 845, 847 (1980); *Sain v. Silvestre*, 78 Cal. App. 3d 461, 472, 144 Cal. Rptr. 478, 485-86 (1978); *Pike v. Tuttle*, 18 Cal. App. 3d 746, 751, 96 Cal. Rptr. 403, 406 (1971).

deferred interest must be obligatory in order to assure priority of the entire SAM lien.

An obligatory future advance is one which, under the loan terms, is mandatory for the lender to make.<sup>157</sup> The accrual of contingent deferred interest is mandatory under the terms of a SAM loan, and is dictated by factors outside the lender's control. It is therefore identical to an obligatory future advance. Additionally, in the case of both contingent deferred interest and future advances, the borrower's debt increases pursuant to an objective standard. Finally, a potential junior lienholder can ascertain the potential scope of a SAM lien as easily as that of an obligatory future advance. As a result, the lien priority for contingent deferred interest should be determined by the rules applicable to obligatory advances.

The rationale for the obligatory future advance rule also supports the analogy between SAMs and future advances. In commenting on the priority of a future advance, a prominent scholar stated that because "the mortgage for future advances secures the promise to repay them made at the time the transaction is entered into, it follows that priority dates from the day that promise became binding."<sup>158</sup>

A junior lienor might contest the mandatory nature of contingent deferred interest on the basis that the amount of contingent deferred interest is purely speculative and therefore cannot be something giving notice to a potential junior lienor. However, future advances in an amount dependent on the changing value of the secured property should achieve priority over a subsequent lien. A contract not specifying the precise amount of a future advance may still be obligatory if the parties understand that the lender is required to advance further sums to the borrower.<sup>159</sup>

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157. *Atkinson v. Foote*, 44 Cal. App. at 161, 186 P. at 836; see *Sain v. Silvestre*, 78 Cal. App. 3d at 472, 144 Cal. Rptr. at 485 ("When the beneficiary-lender is not bound to make the future advances, priority as to the *security for the future advances* is determined by the circumstances existing at the time the particular advances were made.").

158. G. OSBORNE, *HANDBOOK ON THE LAW OF MORTGAGES* 195 (2d ed. 1970). See also *Tapia v. Demartini*, 77 Cal. 383, 386-87, 19 P. 641, 643 (1888), in which the court stated: "The mortgage, as against subsequent encumbrancers, becomes a lien for the whole sum advanced from the time of its execution, and not for each separate amount advanced from the time of such advancement, although the right to enforce the collection thereof can only arise upon each advancement being made."

159. *Preble v. Csunger*, 66 Ill. 370 (1872). This is not the same question discussed *supra* in the text accompanying notes 147-54, but arises from the fact that typically the maximum amount of debt to be created under an obligatory future advance is ascertainable, whereas in a SAM the maximum is not ascertainable.

In *Machado v. Bank of Italy*,<sup>160</sup> a \$25,000 loan was made, secured by property appraised at \$72,000. At the time the loan was made, the lender orally agreed to make future advances to the borrower in an amount up to 60% of the appraised value of the secured property. After a junior lien had attached to the secured property, the lender advanced an additional \$25,500 to the borrower. The court rejected the claim that, because the amount of the advance was left open, the usual priority rules as to obligatory advances should be altered.<sup>161</sup>

The uncertain amount of a SAM lien for contingent deferred interest should not render it junior to subsequent liens. Such has always been the case with loans in which the interest rate floats with the lender's prime rate. The same should be true for SAMs. If the recorded security interest adequately notifies junior lienors of the existence of the SAM, which necessarily carries with it the probability of contingent deferred interest, the SAM should have priority. Furthermore, although the precise amount of contingent deferred interest under a SAM may be uncertain, *Buck*, *Machado*, and *Tapia* demonstrate that junior lienors will be deemed to have adequate notice that certain sums will be payable to the senior lienor at a future date. Under these cases no further specificity in the loan documents would be required.

### Restraints on Alienation

Both the common law<sup>162</sup> and California statutory law<sup>163</sup> prohibit unreasonable restraints on the alienation of property. Courts have relied on this doctrine to prohibit a wide variety of restraints on alienation.<sup>164</sup>

Under the common law rule, restrictions which to a certain extent may be analogous to SAMs have been held unenforceable. Section 413 of the Restatement of Property provides a concise summary of the common law rule: "[a] promissory restraint [stating] that the owner of the estate shall pay a certain percentage of the sale price to some designated person, is valid if, and only if, the restraint is valid under the rules stated in sections 406-411."<sup>165</sup> These sections provide the general rules as to when restraints on alienation are valid. Assuming the SAM

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160. 67 Cal. App. 769, 228 P. 369 (1924).

161. *Id.* at 775, 228 P. at 372.

162. See *infra* text accompanying notes 165-67.

163. CAL. CIV. CODE § 711 (West 1954), provides in full that "[c]onditions restraining alienation, when repugnant to the interest created, are void."

164. See *infra* examples set forth in text accompanying notes 170-74.

165. RESTATEMENT OF PROPERTY § 413(2)(b) (1944).

is being placed on fee title, the only relevant section of those just mentioned is section 406, and the only relevant part of that section provides that restraints on alienation are valid only if the "restraint is reasonable under the circumstances."<sup>166</sup>

The Restatement lists several factors that indicate whether a restraint is reasonable or unreasonable. A restraint tends to be reasonable if:

(1) the one imposing the restraint has some interest in land which he is seeking to protect by the enforcement of the restraint;

(2) the enforcement of the restraint accomplishes a worthwhile purpose.

A restraint is unreasonable if:

(1) the restraint is capricious;

(2) the restraint is imposed for spite or malice;

(3) the one imposing the restraint has no interest in land that is benefited by the enforcement of the restraint;

(4) the restraint is unlimited in duration;

(5) the number of persons to whom alienation is prohibited is large.<sup>167</sup>

The Restatement authors provide the following example illustrating section 413: "A [conveys Blackacre] 'to B and his heirs, and B covenants . . . that if he ever sells Blackacre . . . he will pay 25% of the sale price to C.' . . . The promissory restraint is invalid."<sup>168</sup>

The revision committee states that

[w]hen the owner of an estate is required to turn over a percentage of the sale price to some designated person, he is free to sell but unable to realize the full market price. The resulting hesitancy to sell brings such a case within the rules previously stated in §§ 406-411.<sup>169</sup>

Although a SAM in some ways resembles the invalid restraint on alienation described in section 413, a SAM is not an unreasonable restraint. The invalid restraint described in the Restatement involves restrictions in the deed conveying real property; the grantor retains no legitimate interest in the property. The restriction merely permits the grantor to obtain an economic advantage from a future sale of the

166. *Id.* § 406(c).

167. *Id.* comment i; *see also* Missouri State Highway Comm'n v. Stone, 311 S.W.2d 588, 589 (Mo. App. 1958) in which the court considered three factors in determining the reasonableness of a restraint on alienation: (1) the purposes for which the restraint is imposed, (2) the duration of the restraint, and (3) the method of determining the price to be paid. A SAM appears reasonable under these factors.

168. RESTATEMENT OF PROPERTY § 413 comment a, illustration 3 (1944).

169. *Id.* comment g.

property. Under common law criteria, such a restriction is both capricious and unreasonable.

In contrast, a SAM is a security instrument, not a deed restriction. Neither arbitrary nor malicious, it encumbers the property only to the extent necessary to secure an obligation from the owner which enabled it to obtain a loan at a lower, fixed rate of interest. Moreover, as opposed to the restraint described in the Restatement, a SAM lender has an important continuing security interest in the property. Finally, unlike the restraint described in the Restatement, a SAM is limited in duration and has a substantial economic effect. For these reasons, a SAM is not an unreasonable restraint on alienation under common law principles.

Furthermore, no California cases have prohibited a restraint similar to a SAM. Recently, courts have applied California Civil Code section 711<sup>170</sup> to void due-on-sale clauses in deeds of trust or mortgages when those clauses are enforced solely for the purpose of adjusting interest rates.<sup>171</sup> The California courts have also invalidated a deed provision that property cannot be sold without the grantor's consent.<sup>172</sup> A covenant in a deed that property can only be sold to the grantor is also invalid under section 711.<sup>173</sup> Most types of racial and religious restrictions applicable to potential purchasers are also invalid restraints under section 711.<sup>174</sup> Thus, section 711 has been applied to cases where the restraint was both more restrictive and less related to legitimate business or social purposes than SAMs. The language of section 711 and recent case law confirm this conclusion.

Section 711 provides that restraints on alienation are void only when "repugnant" to the property interest concurrently being created or transferred.<sup>175</sup> In the illustration from the Restatement <sup>176</sup> in which "A" grants to "B" on condition that "B" pay over to "C" a percentage of the profits obtained upon resale of the property, that condition would, in an ordinary context, involve an attempt to create a restraint or interest wholly repugnant to the interest purportedly being con-

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170. CAL. CIV. CODE § 711 (West 1954).

171. See *infra* text accompanying notes 181-202.

172. E.g., *Prey v. Stanley*, 110 Cal. 423, 42 P. 908 (1895); *Murray v. Green*, 64 Cal. 363, 28 P. 118 (1883).

173. *Maynard v. Polhemus*, 74 Cal. 141, 15 P. 451 (1887).

174. See, e.g., *Los Angeles Inv. Co. v. Gary*, 181 Cal. 680, 186 P. 596 (1919); *Foster v. Stewart*, 134 Cal. App. 482, 25 P.2d 497 (1933); *Title Guarantee & Trust Co. v. Garrott*, 42 Cal. App. 152, 183 P. 470 (1919).

175. CAL. CIV. CODE § 711 (West 1982).

176. See *supra* text accompanying note 168.

veyed. Certainly in the typical situation, when "A" grants a fee title to "B," "A" no longer has any continuing financial or other interest in the property.<sup>177</sup> In a SAM, however, the lender's taking of an interest in the profits on resale is not repugnant to the security interest being created. Rather, it is complementary to it in that it defines both the amount of interest to be paid on the loan and the time of payment.

Similarly, the California Supreme Court in *Wellenkamp v. Bank of America*<sup>178</sup> stated clearly that restraints on alienation are not automatically void. Rather, one must weigh the degree of the restraint against the justification for its imposition to determine whether the restraint is reasonable.<sup>179</sup>

In the case of a SAM, the degree of restraint is quite small. Unlike the illustration in section 413 of the Restatement, where the owner is unable to retain the full market price and therefore is hesitant to sell,<sup>180</sup> a SAM borrower who is required to pay a portion of the profits to his lender should not be hesitant to sell; the reduction in profit has been offset by a lower fixed interest rate during the term of the loan. The apparent restraint on alienation in the SAM financing device is not, therefore, the unreasonable restraint prohibited by *Wellenkamp* and section 711.

In conclusion, a SAM contains little if any of the restraint contained in the Restatement illustration, but, again unlike the illustration, substantial justification for the restraint exists in a SAM. Accordingly, a SAM does not violate the rule against unreasonable restraints on alienation.

### Due-On-Sale Provisions

A related question is whether, as is typically the case for SAMs, a provision is enforceable which requires the payment of all contingent deferred interest and principal when the secured property is sold. The

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177. Although undoubtedly correct at the time the Restatement of Property was written, it is doubtful that the A-B-C illustration, quoted *supra* in the text accompanying note 168, is an accurate exposition of the law today. For instance, assume an owner of undeveloped property neither wishes, nor has the ability, to undertake the risks and obligations necessary to rezone the property and to put a governmentally approved development plan on it. Nevertheless, doing so would double the per-square-foot value of the property. Although an effort to capture some of the potential increase in value might better be accomplished by a differently structured transaction, it would certainly seem that a deed by such owner on condition that his or her buyer turn over to the seller a percentage of the profits realized as a result of efforts to rezone the property would be justifiable and not a violation of section 711.

178. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

179. *Id.* at 948-49, 582 P.2d at 973, 148 Cal. Rptr. at 382.

180. See *supra* text accompanying note 169.

California legislature exempted statutory SAMs from this potential problem by a specific provision validating acceleration of the loan maturity date when the property is sold.<sup>181</sup> A lender making a nonstatutory SAM should also be able to enforce a due-on-sale provision.<sup>182</sup>

A plethora of recent California cases<sup>183</sup> and commentaries<sup>184</sup> discusses the statutory prohibition of unreasonable restraints on alienation and the applicability of this prohibition to the enforceability of due-on-sale provisions. The seminal case in this area is *Wellenkamp v. Bank of America*,<sup>185</sup> which concerned whether the automatic enforcement of a trust deed's acceleration clause upon sale of the property is an unreasonable restraint on alienation. *Wellenkamp* mandates a balancing test under which the justification for enforcement of a particular restraint must be weighed against the actual practical effect upon alienation that

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181. See *supra* note 63 for text of CAL. CIV. CODE § 1917.162.

182. The following discussion assumes the inapplicability to the particular loan of the Garn Act's validation of due-on-sale clauses. See *infra* text accompanying notes 204-16.

183. Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 102 S. Ct. 3014 (1982); Dawn Inv. Co. v. Superior Court, 30 Cal. 3d 695, 639 P.2d 974, 180 Cal. Rptr. 332 (1982); *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978); *Tucker v. Lassen Sav. & Loan Ass'n*, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974); *La Sala v. American Sav. & Loan Ass'n*, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971); *Garber v. Fullerton Sav. & Loan Ass'n*, 122 Cal. App. 3d 423, 176 Cal. Rptr. 49 (1981); *Wilhite v. Callihan*, 121 Cal. App. 3d 661, 175 Cal. Rptr. 507 (1981); *Panko v. Pan Am. Fed. Sav. & Loan Ass'n*, 119 Cal. App. 3d 916, 174 Cal. Rptr. 240 (1981); *Laguna Royale Owners Ass'n v. Darger*, 119 Cal. App. 3d 670, 174 Cal. Rptr. 136 (1981); *Saucedo v. Mercury Sav. & Loan Ass'n*, 111 Cal. App. 3d 309, 168 Cal. Rptr. 552 (1980); *Guild Wineries & Distilleries v. Land Dynamics*, 103 Cal. App. 3d 966, 163 Cal. Rptr. 348 (1980); *Pas v. Hill*, 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1978).

184. See *Humphrey, Tucker v. Lassen: The Demise of the Due-On-Sale Clause in California*, 10 U.S.F. L. REV. 665 (1976); *Miller, Fixed Price Preemptive Rights in California: The Quality of Mercer is Strained*, 31 HASTINGS L.J. 617 (1980); *Rubens, Right of First Refusal and Waiver of the Right of Judicial Partition*, 14 HASTINGS L.J. 255 (1963); *Valensi, The Due-On-Sale Clause—A Dissenting Opinion*, 45 L.A.B. Bull. 121 (1970); *Zeller, Enforceability of the Due-On-Sale Clause After Tucker*, 52 L.A.B.J. 630 (1977); *Comment, Wellenkamp v. Bank of America: Invalidity of Automatically Enforceable Due-On-Sale Clauses*, 67 CALIF. L. REV. 886 (1979); *Note, The Demise of the Due-On-Sale Clause*, 64 CALIF. L. REV. 573 (1976); *Note, The Case for Relief from Due-On-Sale Provisions: A Note to Hellbaum v. Lytton Savings & Loan Ass'n*, 32 HASTINGS L.J. 431 (1979); *Note, Wellenkamp v. Bank of America: A Victory for the Consumer?*, 31 HASTINGS L.J. 275 (1979); *Note, Beyond Tucker v. Lassen: The Future of the Due-On-Sale Clause in California*, 27 HASTINGS L.J. 475 (1975); *Comment, Due-On-Sale Clauses and Restraints on Alienation: Does Wellenkamp Apply to Federal Institutions?*, 11 PAC. L.J. 1085 (1980); *Note, Reverse Annuity Mortgages and the Due-On-Sale Clause*, 32 STAN. L. REV. 143 (1979); *Comment, Coast Bank v. Minderhout and the Reasonable Restraint on Alienation: Creature of Commercial Ambiguity*, 12 U.C.L.A. L. REV. 954 (1965); *Comment, The Due-On-Sale Clause in California: A Case for Automatic Enforcement by the Private Lender*, 13 U.S.F. L. REV. 639 (1979).

185. 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).



would result if the restraint were enforced.<sup>186</sup> Under this balancing test, the court invalidated due-on-sale clauses unless their enforcement "is reasonably necessary to protect against impairment of [the lender's] security or the risk of default."<sup>187</sup>

The *Wellenkamp* court reasoned that if lenders could accelerate notes on the transfer of secured properties, the transfer of such property might be prohibited entirely because the buyer would be unable to substitute a new loan and the seller would not receive sufficient funds to discharge the existing loan.<sup>188</sup> The court rejected the claim that a lender's interest in maintaining its portfolio at current interest rates outweighs such a restraint. Although the court recognized that lenders face increasing costs due to escalating inflation, it held that due-on-sale clauses are not designed to protect against this type of business risk; lenders, rather than borrowers, should assume the burden of long-term future economic projections.<sup>189</sup>

A due-on-sale clause in a SAM must be analyzed using the *Wellenkamp* balancing test. If the degree of restraint in a SAM is less than in a traditional mortgage, the balance changes. Similarly, any reasonable justification for the acceleration, over and above any increases in the risk of default or any impairment of the security, may be placed in the balance.<sup>190</sup>

The *ratio decidendi* of *Wellenkamp* is that due-on-sale clauses substantially restrain alienation because they require purchasers to make an immediate single payment of the remaining balance of a note rather than assuming the less onerous obligation of paying this amount over

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186. *Id.* at 948-49, 582 P.2d at 973, 148 Cal. Rptr. at 382.

187. *Id.* at 953, 582 P.2d at 977, 148 Cal. Rptr. at 386 (footnote omitted). The court also explicitly overruled *Cherry v. Homes Sav. & Loan Ass'n*, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969), to the extent that *Cherry* permitted the lender to accelerate a debt in order to acquire economic advantage, i.e., adjustment of the interest rate. There have been several California cases decided since *Wellenkamp* which clarify, elaborate, expand and distinguish its holding. See *supra* note 183. The only subsequent California Supreme Court case in this area is *Dawn Inv. Co. v. Superior Court*, 30 Cal. 3d 695, 639 P.2d 974, 180 Cal. Rptr. 332 (1982). This case is significant because it demonstrates the court's unwillingness artificially to restrict the expressed rationale of *Wellenkamp*. In *Dawn Investment*, the court concluded that, "the *Wellenkamp* rule applies to non-institutional lenders and to commercial property." 30 Cal. 3d at 697, 639 P.2d at 974, 180 Cal. Rptr. at 332. The *Dawn* opinion merely affirms the reasoning of *Wellenkamp*. As a result, the balancing test adopted in *Wellenkamp* is still the applicable measuring rule for the determination of the enforceability of a due-on-sale clause.

188. 21 Cal. 3d at 950, 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84.

189. *Id.* at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385.

190. *Id.* at 948-49, 582 P.2d at 973, 148 Cal. Rptr. at 382.

an extended period.<sup>191</sup> In a SAM, a less substantial restraint is imposed because the buyer's options for payment of the current loan do not vary significantly. The purchaser of property encumbered by a SAM must either pay the contingent deferred interest in a single payment upon maturity, if the SAM is assumed, or pay the contingent deferred interest in a single payment upon purchase, if the SAM is not assumed. Thus, unlike traditional mortgages, the purchaser will not have the opportunity simply to continue the installment payments of a previously amortizing loan.

Also, the enforceability of a SAM due-on-sale clause is clearly more justifiable than a due-on-sale provision in a traditional mortgage. In order to protect the security interest, acceleration of the principal portion of a SAM upon sale of the property is more important to SAM lenders than it would be to lenders making traditional loans. *Wellenkamp* establishes that the lender's security interest is not impaired by the failure to accelerate because the purchaser's equity interest in the property assures continued protection from default. The court stated that "the buyer in an outright sale . . . may make a large [cash] down payment on the property, thereby creating an equity interest in the property *in him* which is sufficient to provide an adequate incentive not to commit waste or permit the property to depreciate."<sup>192</sup> *Wellenkamp* states that traditional lenders need protection only against waste and depreciation. A SAM lender must, in addition, protect the potential appreciation of the value of the security.

Several other reasons support the conclusion that a due-on-sale provision in a SAM should be automatically enforceable. First, *Wellenkamp* states that in fixed interest rate mortgage situations, a lender's primary purpose for acceleration is the protection of the average interest rate of its loan portfolio. The court concluded, however, that the due-on-sale clause was not designed or intended for this purpose and that its automatic exercise in the absence of a threat to the lender's security is invalid.<sup>193</sup> In the case of SAM lenders, the motivation for

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191. *Id.* at 950-51, 582 P.2d at 974-75, 148 Cal. Rptr. at 383-84.

192. *Id.* at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385.

193. "Although we recognize that lenders face increasing costs of doing business and must pay increasing amounts to depositors for the use of their funds in making long-term real estate loans as a result of inflation and a competitive money market, we believe that exercise of the due-on clause to protect against this kind of business risk would not further the purpose for which the due-on clause was legitimately designed, namely to protect against impairment to the lender's security that is shown to result from a transfer of title. Economic risks such as those caused by an inflationary economy are among the general risks inherent in every lending transaction. They are neither unforeseeable nor unforeseen." *Id.* at 952, 582 P.2d at 976, 148 Cal. Rptr. at 385 (footnote omitted). *See also* *Tucker v. Lassen Sav. &*

acceleration upon a sale is not to maintain a loan portfolio at current rates. SAM lenders make loans in order to receive a potentially high yield from the contingent deferred interest portion of the loan. Upon sale of the property, the lender no longer has an interest in continuing to carry the loan; the sole purpose for making the loan has been satisfied. Indeed, it may be assumed that many SAM lenders will make loans only on property they believe is undervalued.<sup>194</sup> Thus, upon sale of the property at fair market value and payment of the contingent deferred interest, the lender's entire reason and purpose for making the SAM is extinguished at that point, and the most appropriate time for calling the loan due has arrived.

Examination of the contrasting reasons that SAM and traditional lenders have for making loans highlights this point. Traditional thirty-year, fixed-interest loans are long-term investments providing the lender with a steady and predictable income. In a sense, the borrower treats such a loan as a fixed feature of the property.<sup>195</sup> Thus, at the initiation of the loan, the parties do not contemplate that the loan will be accelerated for any reason other than default or, as a result of sale, the threat of default. SAM lenders, however, desire a high yield from the contingent deferred interest payable when the property is sold. The lender and the borrower, for economic purposes,<sup>196</sup> are essentially co-owners. In this relationship, termination of the contractual arrangement is expected, by both borrower and lender, upon sale of the common asset. Thus, the reason SAM lenders accelerate loans upon sale is not that the loan has ceased to yield at current interest rates. Rather, SAM lenders must accelerate upon sale because the purpose of the transaction has been fully satisfied. In short, to deny SAM lenders the right to accelerate upon sale is to deny the essential feature of a SAM loan, the right to share appreciation. If owners can gain the profits of appreciation upon sale but lenders cannot, then, in view of the contin-

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Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974), holding that a lender's interest in maintaining its portfolio at current interest rates does not justify the restraint imposed by the exercise of a "due-on" clause upon the execution of an installment land contract by the borrower.

194. Whether a SAM is made when property is initially financed or as a refinancing device, SAM lenders obviously will intend to lend only on properties that are undervalued, or which have substantial potential for appreciation, in order to maximize potential future appreciation.

195. For instance, it is standard practice for appraisers to consider the nature of a property's liens in assessing its value; a long-term, low interest rate loan may significantly increase the value of a parcel.

196. But only for economic purposes. The lender is not legally a co-owner. See *infra* text accompanying notes 274-318, 379-92.

gent deferred interest aspect, there would be no true shared appreciation.

A second reason for allowing acceleration upon a sale relates only to SAMs in which the principal is not amortized over the term of the loan. If an unamortized SAM with a twenty-year term is not accelerated upon a sale, the lender's risk of default increases. For example, assume that a lender makes a \$100,000, twenty-year SAM, and the property is sold after fifteen years. If the SAM is not payable in full at the time of sale, the purchaser assumes an obligation which includes a substantial burden to make full payment of the principal and contingent deferred interest in five years, while the original borrower walks away from the sale transaction with the property's total appreciation pocketed in cash.

The final and most compelling reason for enforcement of SAM due-on-sale provisions is found in the California SAM statute. The legislative findings in Civil Code section 1917.162(b) justify the enforcement of a due-on-sale clause by a nonstatutory SAM lender. The legislature found and declared that although longer term financing was desirable in order to reduce housing costs, the "additional risks" inherent in SAMs are greater with longer term loans, but the risk is reduced with an enforceable due-on-sale clause.<sup>197</sup> In short, section 1917.162(b) constitutes a legislative declaration that due-on-sale clauses are justifiably included in SAMs because such clauses provide SAM lenders necessary and appropriate protection from the "additional risks" inherent in SAMs as compared with traditional financing. Therefore, the legislature found it necessary in section 1917.162(a) to validate due-on-sale clauses in statutory SAMs.<sup>198</sup> Although the courts are not obligated to implement this declaration of legislative intent with respect to nonstatutory SAMs, there are two reasons why the courts will give weight to it.

First, section 1917.162(b) appears to have been intentionally drafted as a statement of legislative policy applicable to all SAMs, not merely to statutory SAMs. Throughout the remainder of the statute, including section 1917.162(a), statutory SAMs are referred to as

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197. CAL. CIV. CODE § 1917.162(b) (West Supp. 1982).

198. "The legislature finds and declares that potential exposure to liability for enforcement of a due-on sale clause consistent with Section 711, as interpreted by the courts, makes use of such a provision impractical. Moreover, the additional risks to the lender inherent in *shared appreciation financing* are greater with longer loan terms (which are more desirable from the standpoint of housing affordability), but this risk is reduced with an enforceable 'due-on sale' clause. Therefore, in order to facilitate *shared appreciation financing*, it is necessary to establish the exceptions specified in subdivision (a)." *Id.* (emphasis added).

"shared appreciation loans,"<sup>199</sup> a defined term meaning loans conforming to the provisions of the code.<sup>200</sup> In setting forth the reason that *Wellenkamp* should be inapplicable to SAMs, however, the legislature did not utilize the defined term; rather, it referred to "shared appreciation financing."<sup>201</sup> It appears that the legislature intended the findings in section 1917.162(b), in conjunction with section 1917.110,<sup>202</sup> to be treated as a legislative declaration of public policy favoring enforcement of due-on-sale clauses in all SAMs.

Second, under the balancing test of *Wellenkamp*, adequate justification for automatic enforcement of due-on-sale clauses exists. Enactment of section 1917.162(b) shows that the legislature found such enforcement would reduce what would otherwise be greater risks inherent in all SAMs, both statutory and nonstatutory, and further, that the degree of reduction is, at least in longer term loans, enough to make a difference in whether the lender is willing to make a SAM. Courts should conclude that due-on-sale clauses in SAMs are sufficiently distinguishable from due-on-sale clauses in traditional mortgages to justify a lender's automatic acceleration of the principal and contingent deferred interest upon sale of the secured property.

### The Garn Act

The Garn-St. Germain Depository Institutions Act of 1982 (the "Garn Act")<sup>203</sup> is an attempt to revitalize the housing industry by both strengthening the financial stability of home mortgage institutions and insuring the availability of home mortgage loans. The Garn Act contains many technical provisions regarding the operation of banks, savings and loans, thrifts and credit unions. Two sections of the Garn Act will also affect SAMs. Section 341 of the Garn Act provides in many instances for the specific preemption of state laws and regulations that prohibit the enforcement of due-on-sale clauses with respect to real property loans. Title VIII of the Garn Act creates a federal preemption of state laws relating to certain alternative mortgage transactions, including SAMs.

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199. *E.g., id.* §§ 1917.131-1917.133, 1917.160 (West Supp. 1982).

200. "Shared appreciation loan" means any loan made pursuant to this chapter upon the security of owner-occupied real property of a type specified in Section 1917.130, and in connection with which the lender has a right to receive a share of the appreciation in the value of the security property. "Shared appreciation loan" includes a deed of trust and any evidence of debt issued in connection with the loan." *Id.* § 1917.120(j) (West Supp. 1982).

201. *See supra* note 198.

202. *See supra* text accompanying note 58.

203. Pub. L. No. 97-320 § 341, 96 Stat. 1469 (1982).

*Section 341*

With one exception, section 341 validates the enforceability of due-on-sale clauses in real property loan documents regardless of when made or transferred.<sup>204</sup> Particularly significant is the validation of due-on-sale clauses in loans made by private parties, as well as by state and federal institutions and governmental agencies.<sup>205</sup> Additionally, the Garn Act affects loans on commercial, as well as residential, properties.<sup>206</sup>

Subsection (d) of section 341 lists specific transfers, such as junior encumbrances, intrafamily transfers, and others, where a lender is prohibited from exercising a due-on-sale clause.<sup>207</sup> This list may be supplemented in regulations prescribed by the FHLBB. This subsection purports to apply to all loans, thereby also preempting state law.

The Garn Act does not remove all uncertainties in the due-on-sale area. For instance, in California it is not perfectly clear which date is the commencement date of the period for defining "excepted contracts," i.e., contracts not presently affected by the Garn Act.<sup>208</sup> Although generally the *Wellenkamp* decision (August 25, 1978) is considered the death knell of due-on-sale clauses in California,<sup>209</sup> arguably the date of enactment of section 711 of the Civil Code, which forbids unreasonable restraints against alienation (1872),<sup>210</sup> or the date of an earlier Supreme Court decision, such as *La Sala v. American Sav-*

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204. The sole exception is "excepted contracts"—real property loan contracts involving lenders other than federal savings and loan associations or federal savings banks where the loans were made or assumed, or where the property was transferred "subject to" the lien, during the period between (a) the date the state adopted a statute prohibiting the exercise of a due-on-sale clause or the date on which the highest court of the state (or, if the highest court has not acted, the next highest court if the decision applies statewide) rendered a decision prohibiting such exercise, and (b) October 15, 1982.

As to an "excepted contract," the Garn Act overrides contrary state law only upon a transfer of the property occurring on or after three years following the date of enactment of the Garn Act (October 15, 1982) unless prior to the third anniversary either the applicable state legislature enacts legislation, or the Comptroller of the Currency (as to national banks) or the National Credit Union Administration Board (as to federal credit unions) prescribes regulations that otherwise regulate such a loan. *Id.* § 341(c)(1). Lenders under excepted contracts may nonetheless accelerate the loans if any successor or transferee of the borrower does not meet customary credit standards applied to loans secured by similar property. Otherwise lenders may not enforce due-on-sale clauses in excepted contracts on the basis of transfers occurring prior to enactment of the Garn Act. *Id.* § 341(c)(2).

205. *Id.* § 341(a)(2).

206. *Id.* § 341(a)(3).

207. *Id.* § 341(d).

208. *See supra* note 204.

209. *See supra* note 185 & accompanying text.

210. CAL. CIV. CODE § 711 (West 1980).

*ings & Loan Association* (October 21, 1971)<sup>211</sup> or *Tucker v. Lassen Savings & Loan Association* (October 10, 1974),<sup>212</sup> could be the date from which the critical period should be measured. Two cases, in dicta, confirm that the date of *Wellenkamp* is the relevant date.<sup>213</sup> A third case appears so to hold.<sup>214</sup>

The effect of section 341 on SAMs is obvious. Although statutory SAMs are statutorily exempt from state laws restricting the enforceability of due-on-sale clauses,<sup>215</sup> nonstatutory SAM lenders were not statutorily exempt from such restrictions before enactment of the Garn Act. The Garn Act provides all nonstatutory SAM lenders the same ability to enforce due-on-sale clauses that statutory SAMs lenders are given by the California SAM statute, the sole exception being "excepted contracts."<sup>216</sup>

### *Title VIII*

The purpose of title VIII of the Garn Act<sup>217</sup> is to eliminate the discriminatory impact of FHLBB regulations by authorizing any "housing creditor" to make, purchase and enforce an "alternative mortgage transaction" in accordance with FHLBB regulations, notwithstanding any state constitution, law, or regulation prohibiting or limiting such transactions.<sup>218</sup> The result of title VIII is that housing creditors may now make loans that comply with the less restrictive of either FHLBB regulations or applicable state law.

An "alternative mortgage transaction" is defined broadly in title VIII to include any loan or credit sale secured by residential real property, other than a fixed-rate, fixed-term loan, subject to FHLBB regulatory definition.<sup>219</sup> A "housing creditor," among other things, is "any person who regularly takes loans, credit sales or advances secured by

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211. 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

212. 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

213. *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 102 S. Ct. 3014, 3031 n.24 (1982); *Henn v. Henn*, 26 Cal. 3d 323, 328, 605 P.2d 10, 12, 161 Cal. Rptr. 502, 504 (1980).

214. *Garfinkle v. Wells Fargo Bank*, 135 Cal. App. 3d 514, 518-19, 185 Cal. Rptr. 401, 404 (1982).

215. The legislative history is in accord. See S. REP. NO. 536, 97th Cong., 2d Sess. 22 n.1, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 3054, 3076. See *supra* text accompanying note 42.

216. As discussed *supra* in the text accompanying notes 181-202, due-on-sale clauses in SAMs should be enforceable even absent the federal preemption.

217. Pub. L. No. 97-320 §§ 801-07, 96 Stat. 1469, 1545-48 (1982).

218. *Id.* §§ 802-804.

219. *Id.* § 803(1).

interests in [residential real property].”<sup>220</sup>

Title VIII expressly permits states to avoid the application of its provisions.<sup>221</sup> Section 805 provides that if a state, within three years of the effective date of the Garn Act, adopts a law or passes a referendum avoiding application of title VIII, then the title VIII preemption shall apply only to alternative mortgage transactions entered into prior to the effective date of such law or referendum and subsequent to the effective date of title VIII.<sup>222</sup>

One ambiguity of title VIII is whether it is retroactive. Since section 804(a) of the Act permits housing creditors to “make, purchase and *enforce* alternative mortgage transactions,”<sup>223</sup> it could be argued that a housing creditor may now enforce a loan made before the effective date of the Garn Act that did not comply with state law existing at the time the loan was made but did conform to FHLBB regulations existing at the time the loan was made. Since the Garn Act does not expressly apply retroactively, and since retroactive application might raise constitutional objections, it is probable that title VIII will not be construed to be retroactive.

In order to understand the effect of title VIII on SAMs, it is necessary to analyze the FHLBB regulation of SAMs. On September 30, 1980, the FHLBB issued proposed regulations for SAMs.<sup>224</sup> The FHLBB received 350 comments.<sup>225</sup> After reviewing the comments, however, the FHLBB determined that further staff work was needed on several issues raised by the comments. Therefore, no final action on the proposal was taken at that time.

On May 7, 1982, the FHLBB issued new proposed regulations.<sup>226</sup> In the preface to the new proposed regulations, the FHLBB stated that the major problem raised by the initially proposed regulations resulted from the excess of constraints contained therein. In response to this problem, the 1982 proposed regulations were much less restrictive.

The 1982 proposed regulations became final rules on August 11, 1982.<sup>227</sup> The final regulations amend section 545.6-2 of the Code of Federal Regulations to provide that a federal association may make, sell, purchase, participate or otherwise deal in loans that provide that a

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220. *Id.* § 803(2)(C).

221. *Id.* § 805.

222. *Id.*

223. *Id.* § 804(a) (emphasis added).

224. *See supra* note 21.

225. 47 Fed. Reg. 19,711, 19,713 (1982).

226. *Id.* at 19,711.

227. *Id.* at 36,612 (to be codified at 12 C.F.R. § 545.6-2).



portion of the consideration to be received by an association in return for making a loan may be interest in the form of a percentage of the amount by which the current market value of the secured property, during the loan term or at maturity, exceeds the original appraised value.<sup>228</sup> The final FHLBB SAM regulations do not limit the term, amount, percentage or other substantive provisions of SAMs. However, the regulations do not expressly exempt SAM lenders from usury laws, priority questions or other legal questions discussed in this Article.

Title VIII in conjunction with the current FHLBB regulations does not directly benefit the California SAM lender because California law does not expressly restrict a lender's ability to make nonstatutory SAMs.<sup>229</sup> Title VIII, however, may offer future SAM lenders some comfort. California SAM lenders are only limited in their ability to make SAMs by the considerations discussed in this Article. Although SAM lenders should not fear these considerations, it would simplify matters if California or federal law addressed these issues. Thus, if future FHLBB regulations specifically permit lenders to make SAMs notwithstanding the considerations just described, the Garn Act would preempt any arguably contrary state law. Unless FHLBB regulations change, however, title VIII will have little effect on California SAM lenders.

### Redlining

Lenders making traditional real property loans routinely examine only two factors in assessing the security: the appraised value of the property and the loan-to-value ratio.<sup>230</sup> Because the contingent deferred interest element of a SAM represents a substantial portion of the lender's anticipated return, a SAM lender considers a third factor before making a loan: the likelihood that the property will appreciate in value. Factors such as neighborhood trends, the age of the secured property, and the general condition of the surrounding property affect the rate of appreciation of a particular parcel.<sup>231</sup> SAM lenders relying on these and similar factors in evaluating a proposed loan must avoid violating state and federal antiredlining statutes.

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228. *Id.* at 36,618 (to be codified at 12 C.F.R. §§ 545.6 & 545.6-2(a)(2)(iv)).

229. *See supra* note 67.

230. *Cf. Gallagher, Computing the Lender's Yield on an Equity Participation Mortgage*, MORTGAGE BANKING, Feb. 1981, at 33.

231. *See Angell & Wardrep, Evaluating the Shared Appreciation Mortgage*, MORTGAGE BANKING, Apr. 1981, at 39; Iezman, *Equity*, *supra* note 81, at 517.

Redlining is a policy either to exclude certain geographical areas from consideration for home mortgages or to vary the terms and conditions of loans within certain geographical areas.<sup>232</sup> At least one California statute prohibits any consideration of neighborhood trends.<sup>233</sup> Thus, a SAM lender may be forced to choose between violating state or federal antiredlining laws or foregoing appropriate economic analysis of the contemplated loan.

A finance industry task force identified redlining as an issue requiring "further analysis" before a SAM program is adopted.<sup>234</sup> Although the California legislature considered this issue when developing the California SAM statute,<sup>235</sup> the statute itself does not address the redlining issue. Consequently, this Article next examines the antiredlining statutes to determine whether they are applicable to the procedures a lender would use to evaluate making statutory and

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232. Special Comment, *Redlining: Potential Civil Rights and Sherman Act Violations Raised by Lending Policies*, 8 IND. L. REV. 1045 (1975).

233. CAL. HEALTH & SAFETY CODE §§ 35800-35854 (West Supp. 1982).

234. "Our major concern with the use of a shared appreciation mortgage is with respect to the potential for discriminatory lending. We are not satisfied with the Federal Home Loan Bank Board's comment that 'accordingly, while an association may, as a matter of sound business practice, seek to concentrate SAMs in areas or types of housing that it believes will appreciate rapidly, it may not limit the availability of these instruments to certain neighborhoods. To the extent a policy is discriminatory in fact, an association must be prepared to demonstrate that its policy achieves a genuine business need which cannot be achieved by means which are either not discriminatory in effect or less discriminatory in effect.'

It is our view that certain neighborhoods in which property values are not appreciating rapidly will be, for business purposes, excluded from shared appreciation mortgage lending. In order to avoid a practice with a discriminatory effect, some method must be devised for insuring a fair mix of mortgage instruments in all communities. We believe that further analysis of this particular problem is required prior to the adoption of the shared appreciation mortgage instrument." Alternative Mortgage Instrument Task Force of the Federal Home Loan Bank Board (Dec. 29, 1981) (as quoted in DEP'T OF CONSUMER AFFAIRS, STATE & CONSUMER SERVICES AGENCY, ENROLLED BILL REPORT (A.B. 2168), 1981-82 Reg. Sess. 4 (1981). Others have noted this problem. See, e.g., Kmiec, *supra* note 81, at 318-24; Letter from California Association of Realtors to Office of the Secretary, FHLBB, at 5 (Nov. 25, 1980).

235. Commenting upon the initial draft of the California SAM statute, a legislative analyst for the California Department of Consumer Affairs noted the redlining question and came to the unsupported and facially erroneous conclusion that SAMs would be discriminatory because they would aid only the "more affluent" home purchaser. "While very little analysis of the potential for unlawful discrimination has been performed, it seems likely that SAMs will be used primarily by builders in the sale of new and expensive subdivision homes, not by lenders financing the construction of low income housing or the resale of already existing homes. To the extent that is true, the SAM will be discriminatory in the sense that it will be used mainly to finance homeownership [sic] by the more affluent home purchasers. DEP'T OF CONSUMER AFFAIRS, STATE & CONSUMER SERVICES AGENCY ENROLLED BILL REPORT (A.B. 2168), 1981-82 Reg. Sess. 4 (1981).

nonstatutory SAM loans.<sup>236</sup>

The only federal statutes or regulations establishing an express antiredlining prohibition are the new rules promulgated by the FHLBB, which apply only to member institutions of the Federal Home Loan Bank.<sup>237</sup> These regulations prohibit discrimination in lending based on the age or location of a home<sup>238</sup> and are rather ambiguous.<sup>239</sup> Inasmuch as these regulations<sup>240</sup> are no more restrictive than the California

236. The antiredlining statutes will not, of course, be applicable to commercial SAMs.

237. 12 C.F.R. §§ 528.1-528.8, 531.8 (1982). On the federal level, two sources of housing regulation, the Fair Housing Act, 42 U.S.C. §§ 3601-3619 (1976 & Supp. IV 1980) and the Equal Credit Opportunity Act, 15 U.S.C. §§ 1691-1691(f) (1976 & Supp. IV 1980), while not specifically prohibiting redlining, do prohibit various forms of racial discrimination. The Fair Housing Act establishes comprehensive rules prohibiting all forms of housing discrimination. One provision states: "[I]t shall be unlawful for any . . . enterprise whose business consists in whole or in part in the making of commercial real estate loans, to deny a loan . . . or to discriminate . . . in the fixing of the amount, interest rate, duration, or other terms . . . because of . . . race, color, religion, sex, or national origin . . ." 42 U.S.C. § 3605 (1976). The Equal Credit Opportunity Act, applicable to all "creditors," prohibits discrimination on the basis of race, color, religion, national origin, sex, marital status, and age in the extension of credit. 15 U.S.C. § 1691(a)(1) (1976).

As SAM lenders have no legitimate reasons for discriminatorily denying SAMs, these two statutes should not affect SAM lending practices. However, under the racial impact test devised by the federal courts, lenders may be held liable under either of these Acts for lending practices having a disproportionate effect on minorities. The racial-impact test was first adopted in *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971) (Civil Rights Act of 1964). The test was later applied to housing in *Metro. Hous. Dev. Corp. v. Village of Arlington Heights*, 558 F.2d 1283 (7th Cir. 1977), *cert. denied* 434 U.S. 1025 (1978), and in *United States v. City of Blackjack*, 508 F.2d 1179 (8th Cir. 1974). Thus, SAM lenders must carefully avoid any improperly disproportionate effects in offering SAMs. SAM lenders may avoid the otherwise possible application of the racial impact test by invoking the business necessity doctrine. In *Griggs*, the Supreme Court held that the racial impact doctrine was inapplicable if the challenged practice was justified by a business necessity. Under this doctrine, a practice absolutely vital to the proper functioning of a business enterprise may be permitted even if it produces a discriminatory effect. To qualify under the business necessity exception: (1) the business purpose must be an important business purpose sufficiently compelling to override its discriminatory effect; (2) the challenged practice must effectively carry out the business purpose it allegedly serves; and (3) there must be no alternative policies or practices available which would accomplish the business purpose advanced as well or better but with a less discriminatory impact. For a discussion of the business necessity doctrine, see, e.g., Note, *The Red-Lining Battle Continues: Discriminatory Effect vs. Business Necessity Under the Fair Housing Act*, 8 B.C. ENVTL. AFF. L.J. 357 (1979). Generally, the commentators have suggested that the doctrine be limited, a suggestion the courts have followed. The three-prong test noted above is substantially identical to that contained in the California Administrative Code, discussed *infra* in text accompanying note 247. Most of the same considerations would apply.

238. 12 C.F.R. § 531.8 (1982).

239. For a discussion of these regulations, see Kmiec, *supra* note 81, at 320-22.

240. Whereas the FHLBB regulations apply only to member institutions of the Federal Home Loan Bank, the California antiredlining provisions apply to any "financial institution," as defined by statute. CAL. HEALTH & SAFETY CODE §§ 35805(c) (West Supp. 1982).

antiredlining provisions, this discussion will focus on the latter.

The legislature intended<sup>241</sup> that California antiredlining prohibitions<sup>242</sup> "prevent discrimination in the provision of financial assistance for financing or refinancing the purchase, construction, rehabilitation, or improvement of housing accommodations because of conditions, characteristics, or trends in the neighborhood or geographic area surrounding the security property."<sup>243</sup> Accordingly, the antiredlining statute prohibits discrimination based upon consideration of "conditions, characteristics, or trends in the neighborhood or geographic area surrounding the housing accommodation, unless the financial institution can demonstrate that such consideration in the particular case is required to avoid an unsafe and unsound business practice."<sup>244</sup>

The return on the SAM lender's investment depends on the appreciation in value of the secured property. As no generally accepted test exists for determining whether certain property will appreciate in value, it is difficult to predict what factors a SAM lender will consider before making such a loan. However, the nature of the factors considered determines whether a SAM lender is required to justify consideration of the factor as necessary "to avoid an unsafe and unsound business practice."

The age of a home, for instance, may be one factor used to determine its potential rate of appreciation.<sup>245</sup> Mere consideration of the age of a particular house no more violates the redlining prohibition than does consideration of the value of a house. If a SAM lender, however, is tempted to consider the conditions, characteristics, or trends in the neighborhood or geographic area surrounding the housing accommodation, then it might arguably run afoul of the antiredlining rules.<sup>246</sup>

For example, potential appreciation may, in many lenders' opinions, be affected by the neighborhood's affluence, whether neighborhood values are static or climbing, and other similar factors. If a SAM

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241. The legislative findings regarding California's antiredlining statutes illuminate the legislative intent: "With respect to certain geographic areas, financial institutions have sometimes denied financial assistance or approved assistance on terms less favorable than are usually offered in other geographic areas, regardless of the creditworthiness of the applicant or the *condition of the real-property security offered* . . . ." *Id.* § 35801(e) (West Supp. 1982) (emphasis added).

242. *Id.* §§ 35801-35833 (West Supp. 1982). The regulations enacted pursuant to these statutes are set forth in title 21 of the California Administrative Code §§ 7100-7117.

243. CAL. HEALTH & SAFETY CODE, § 35802(a) (West Supp. 1982) (emphasis added).

244. *Id.* § 35810 (emphasis added).

245. Depending upon other facts, it may be expected to appreciate or to depreciate. *See* Kmiec, *supra* note 81, at 318-19 & n.64.

246. *Id.*

lender takes into account these neighborhood considerations, it may be presumed to have violated the antiredlining prohibitions unless it can demonstrate that such considerations are necessary to avoid an "unsafe and unsound business practice."

No case law discusses the parameters of the phrase "unsafe and unsound business practice." The statute itself neither defines nor explains this term. The California Administrative Code provides some useful analysis of the problem in section 7105.1, suggesting three questions to be considered in deciding whether it would be an "unsafe and unsound business practice" for the lender not to consider neighborhood trends: (1) whether a legitimate business purpose is served by considering neighborhood trends, characteristics and conditions; (2) whether such considerations effectively achieve this purpose; and (3) whether any non-discriminatory practices would accomplish this purpose equally well.<sup>247</sup>

The first question, whether consideration of neighborhood characteristics serves a legitimate business purpose, can be answered affirmatively by the SAM lender. Lenders will make SAMs primarily to expand the pool of potential borrowers and to create the possibility of earning a higher return.<sup>248</sup> The return must be sufficiently high to allow lenders to meet their costs and to encourage lenders to remain in the residential loan markets.<sup>249</sup> Consideration of neighborhood trends, assuming valid prognostication of future appreciation, will protect the lender's investment. Thus, the legitimate business purpose to be served by consideration of neighborhood trends is allowing, facilitating and encouraging a lender to make SAM loans on a basis that enlarges the lender's pool of borrowers without reducing the lender's ultimate overall return below a minimum acceptable level.

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247. "[I]f it is clear that a practice has a discriminatory effect against a protected group, the burden shifts to the financial institution to demonstrate that the practice is *required to achieve a legitimate business purpose*. Under this concept, each policy or practice is evaluated by first asking whether or not the policy or practice is discriminatory in effect. If the answer to this is 'yes,' then the financial institution will be considered to be in violation of the regulations unless it can demonstrate that the practice is required to achieve a legitimate business purpose." Additionally, "the business purpose must be an important business purpose sufficiently compelling to override any discriminatory impact, the challenged practice must effectively carry out the business purpose it is alleged to serve, and there must be available no acceptable alternative policies or practices which would better accomplish the business purpose advanced—or accomplish it equally well—with a lesser discriminatory impact." 21 CAL. ADMIN. CODE tit. 21, R. 7105.1 (1979) (emphasis added).

248. See *supra* text accompanying notes 24-25.

249. Cf. CAL. BUS. & TRANSP. AGENCY, STATE BANKING DEP'T, ENROLLED BILL REPORT (A.B. 2168), 1981-82 Reg. Sess. (1981); CAL. BUS. & TRANSP. AGENCY, DEP'T OF CONSUMER AFFAIRS, ENROLLED BILL REPORT (A.B. 2168), 1981-82 Reg. Sess. at 1 (1981).

The second question, whether consideration of neighborhood trends, characteristics and conditions effectively achieves the legitimate business purpose, is presently unanswerable due to the absence of available empirical evidence. The practice might be acceptable in one location and not in another, depending upon the history, demographics, and other factors unique to the locale. Each lender will need to analyze whether the practices and criteria it wishes to use are effective in carrying out the legitimate business purposes described in the foregoing paragraph. Nevertheless, one would expect an empirical study to show actual returns on ten-year SAMs to be greater in areas where home price trends are up at the time the loan is made, or are expected to go up, than in areas where price trends are not increasing or are not expected to increase. Thus limiting SAM loans to certain areas, though perhaps constituting redlining, may nevertheless effectively carry out the legitimate business purpose.

In analyzing this question, it must be emphasized that a SAM lender has legitimate concerns beyond those of traditional lenders. A lender making a standard loan of 80% of the property value has little legitimate concern whether the value remains static or even declines somewhat. A SAM lender depends on a continued minimum appreciation in order to render the investment a profitable one.

The final question of the three, whether any nondiscriminatory practices would accomplish the legitimate business purpose equally well, is also ultimately factual. If, for instance, it can be assumed in answer to the second question above that consideration of neighborhood value trends are effective in achieving a legitimate business purpose, then a cause and effect relationship can also be assumed. To that extent, "no acceptable alternative policy or practices" would accomplish the business purpose in the same or better way. Further, no other alternative mortgage program established in the last fifty years has lowered the interest rates paid by borrowers.<sup>250</sup> Thus, there appear to be no nondiscriminatory alternatives.

From a broader perspective, application of the antiredlining provisions in a manner that would prevent SAM lenders from making necessary or appropriate investment decisions would inhibit the California legislature's ability to encourage shared appreciation financing.<sup>251</sup> Interpreting antiredlining statutes in ways that forestall or discourage

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250. Indeed, most AMIs are designed to permit a lender to raise the interest rate according to an independent standard.

251. CAL. CIV. CODE § 1917.110 (West Supp. 1982).

lenders from making SAMs would effectively eliminate one of the few loan programs designed to aid lower-income borrowers.

Other portions of the California antiredlining provisions support this conclusion by suggesting that the economic factors SAM lenders must consider are both permissible and appropriate.<sup>252</sup> The regulations permit lenders to apply certain inherently subjective criteria in determining whether a loan will be granted, including consideration of the possibility that market value may decline as a result of the local geographic factors.<sup>253</sup> If a lender can document that the property's fair market value is likely to decrease during the early years of the mortgage term, he may deny the loan or adjust the loan-to-value ratio, increasing the down payment required of the borrower.<sup>254</sup> The lender may also require a shorter term to maturity, thereby increasing the borrower's monthly payment.<sup>255</sup> By analogy, SAM lenders should be able to consider the prospect for appreciation of the property, notwithstanding California antiredlining legislation.<sup>256</sup>

### Unruh Civil Rights Act

The California Unruh Civil Rights Act<sup>257</sup> prohibits business establishments from discriminating against or refusing to trade with any per-

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252. The regulations appear to adopt a less rigid view of the statute than the statutory language might otherwise suggest.

253. CAL. ADMIN. CODE tit. 21, R. 7106(b)(1) (1979).

254. *Id.*

255. *Id.*

256. To implement these policies, the Administrative Code provides: "If a financial institution can document that one or more factors relating to the geographic area closely surrounding the security property are likely to cause the fair market value of the security property to decrease during the early years (three to five years) of the mortgage term, even assuming the availability of nondiscriminatory financing in a geographic area, then the financial institution, in determining whether and under what terms and conditions to grant financial assistance, may make adjustments or additional requirements in the loan terms. Provided, however, that no adjustment or additional requirement made pursuant to this subsection shall exceed the minimum reasonably estimated to be required for the security property to continue to be an adequate security for the loan." CAL. ADMIN. CODE tit. 21, R. 7106(b)(1) (1979).

Further, the regulations provide: "Decisions on reasonable loan security shall be based solely upon the value of the individual structure offered as security unless the financial institution can identify and document specific neighborhood or geographic conditions that affect its present or short-range future value (e.g., three to five years). Such conditions may include current market trends based upon actual transactions involving comparable property and trends indicating increasing numbers of abandoned, vandalized, or foreclosed properties in the immediate vicinity of the security property." *Id.*, R. 7106(e) (1979).

257. CAL. CIV. CODE §§ 51-53 (West 1954 & Supp. 1982) ("Unruh Civil Rights Act"). Though by statutory definition the term Unruh Civil Rights Act is comprised of only Civil Code § 51, herein we have used the more common broad definition.

son because of such person's race, creed, religion, color, national origin, or sex.<sup>258</sup> In deciding *In re Cox*,<sup>259</sup> the California Supreme Court determined that the particular bases of discrimination identified in the Unruh Civil Rights Act were "illustrative, rather than restrictive."<sup>260</sup> Thus, if a business establishment discriminated against or refused to deal with any arbitrarily defined group, it might violate the Unruh Civil Rights Act.

Recently, the broad sweep of the Unruh Civil Rights Act was confirmed in *Marina Point, Ltd. v. Wolfson*.<sup>261</sup> The California Supreme Court held that a landlord's refusal to rent to a group consisting of families with children was an exclusionary policy violating the rights of members of that group.<sup>262</sup> The landlord argued, however, that its exclusionary policy was "reasonable," not "arbitrary."<sup>263</sup> The lower court made a factual finding that children as a group are noisier and more mischievous than adults.<sup>264</sup> Therefore, the landlord argued, he could seek to achieve the legitimate goal of a quiet residential atmosphere by excluding all children.<sup>265</sup>

The supreme court, however, held that the Unruh Civil Rights Act establishes for each individual a right of access to business establishments.<sup>266</sup> Thus, a business establishment may exclude persons only on an individual, not a group, basis, and then only because of legitimately unacceptable characteristics that a particular individual possesses. A business establishment may not reject an individual merely because he or she is a member of a group, even though there is empirical proof that the percentage of individuals in that group having such legitimately unacceptable characteristics is substantially greater than in the population as a whole.<sup>267</sup> Arguably, therefore, making SAMs available only to certain classes of people, such as those with homes within a particular value range or geographic area, violates the Unruh Civil Rights Act. A lender basing its investment decisions solely upon an individual evaluation of each loan applicant, however, would not vio-

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258. *Id.* § 51.5 (West 1954 & Supp. 1982).

259. 3 Cal. 3d 205, 474 P.2d 992, 90 Cal. Rptr. 24 (1970).

260. *Id.* at 212, 474 P.2d at 995, 90 Cal. Rptr. at 27.

261. 30 Cal. 3d 721, 640 P.2d at 115, 180 Cal. Rptr. 496 (1982).

262. *Id.* at 744-45, 640 P.2d at 129, 180 Cal. Rptr. at 511.

263. *Id.* at 725, 640 P.2d at 117, 180 Cal. Rptr. at 498.

264. *Id.* at 729, 640 P.2d at 120, 180 Cal. Rptr. at 501.

265. *Id.* at 736, 640 P.2d at 124, 180 Cal. Rptr. at 506.

266. *Id.* at 740, 640 P.2d at 126, 180 Cal. Rptr. at 508.

267. *Id.* at 738-39, 640 P.2d at 125, 180 Cal. Rptr. at 507.



late the Unruh Civil Rights Act because no group discrimination occurs.

Ample justification also exists for rejecting the application of the Unruh Civil Rights Act to lenders making SAMs available only to certain types or groups of properties. First, *Marina Point* indicates that a reasonable discriminatory policy may be upheld if the policy "serves any similarly compelling societal interest."<sup>268</sup> The court gave as an example the right of landlords to bar, as a group, families with children from apartment housing designed specifically for the aged. The court based its conclusion on legislative history indicating that the California legislature had implicitly indicated that housing for the elderly was a desirable public policy.<sup>269</sup> With respect to SAMs, the California legislature has made an express legislative determination that SAMs must become an integral element of the financing industry in California.<sup>270</sup> Thus, to the extent a lender must establish otherwise discriminatory procedures and practices in order to set up and operate a feasible SAM lending program, the lender would not be in violation of the Unruh Civil Rights Act. Such a lending program would be a "specialized institution designed to meet a social need,"<sup>271</sup> in that it "alleviates" rather than "exacerbates . . . the state's specialized housing needs."<sup>272</sup>

Second, to the extent that a SAM lender does discriminate, the Unruh Civil Rights Act is not violated because the discriminatory choices are based on the characteristics of property, not people. The Unruh Act prohibits businesses from refusing to deal with persons on the basis of personal characteristics imputed to an individual because he or she is a member of a group. If, however, the likelihood of appreciation is greatest for \$100,000 to \$200,000 homes in a particular geographic area, then a lender's refusal to give a SAM loan on property outside that range would not discriminate against the individual. Instead, the basis for the discrimination would be the nature of the property.<sup>273</sup> Thus, a SAM lender's decision to lend only on certain types of property based on that property's potential for appreciation is not a violation of the Unruh Civil Rights Act.

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268. *Id.* at 743, 640 P.2d at 128, 180 Cal. Rptr. at 510.

269. *Id.* at 742, 640 P.2d at 127-28, 180 Cal. Rptr. at 509-10.

270. CAL. CIV. CODE § 1917.110 (West Supp. 1982).

271. *Marina Point, Ltd. v. Wolfson*, 30 Cal. 3d at 743, 640 P.2d at 128, 180 Cal. Rptr. at 510.

272. *Id.*

273. To argue otherwise is to argue that banks willing to make \$100,000 secured loans on properties worth \$150,000 or more must also be willing to grant such loans on properties worth less than \$100,000.

Further, there is a critical difference between discriminatory policy based on human groups and that based on property groups. It is evident that a particular person does not necessarily possess the same personal characteristics as others in his or her group. Conversely, it is also evident that depressed general values of properties in a specific area have a measurable effect on the value of a particular property within that area. The cause and effect relationship exists because property is, by and large, fungible, whereas people are not.

Finally, even if the cause-and-effect relationship described above did not exist, the Unruh Civil Rights Act would not be violated merely because a lender imputed to a particular piece of property a legitimately unacceptable characteristic generally true of most properties in the same class or grouping. The Act, as construed in *Marina Point*, forbids ascribing to a particular individual the personal characteristics generally true of other persons in his or her group. The Act was not intended to forbid ascribing to a particular piece of property the characteristics generally true of other pieces of property in the same class or grouping. Therefore, the social policy and rationale of the Unruh Civil Rights Act are not applicable.

### Tax Implications

Some of the more difficult legal issues raised by SAMs are the tax consequences for both lenders and borrowers.<sup>274</sup> Unfortunately, there has been little critical commentary on the subject.<sup>275</sup>

The SAM financing device poses tax questions in five principal areas: First, can a lender report receipt of contingent deferred interest as a capital gain, rather than ordinary income, and must a borrower report it as a capital expenditure, rather than as an interest deduction?<sup>276</sup> Second, is contingent deferred interest deductible for the borrower and includible for the lender only in the year in which it is paid, or in each year as it accrues?<sup>277</sup> Third, if contingent deferred interest is not deductible until the note matures, and if it is to be treated as a

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274. The contingent deferred interest feature of SAMs is the complicating element in the tax context. The Internal Revenue Code employs terminology appropriate to more traditional loan situations, e.g., I.R.C. § 163 (1976). The contingent deferred interest feature of SAMs corresponds neither to the terminology used in the Code nor to commonly used accounting terminology.

275. But see Kmiec, *supra* note 81; Levine, *Tax Implications of Shared Appreciation Mortgages*, 59 TAXES 487 (1981); Mooradian & Rosenblatt, *Characterization of Contingent Payments on Shared Appreciation Mortgages*, 57 J. TAX'N 20 (1982).

276. See I.R.C. §§ 163, 1221, 1245 (1976 & Supp. IV 1980).

277. See *id.* §§ 446, 451, 461 (1976 & Supp. IV 1980).

payment of interest, must a SAM borrower take its entire interest deduction for contingent deferred interest in the single taxable year in which the note matures?<sup>278</sup> Fourth, what is the impact of the interest limitation rules of section 163(d) of the Internal Revenue Code ("I.R.C.")?<sup>279</sup> Fifth, how will the imputed interest rules of I.R.C. section 483 be applied if the fixed-rate portion of the interest obligation is less than the minimum rate set by that section?<sup>280</sup>

*Characterization of the Income or Deduction Resulting from Receipt or Payment of the Contingent Deferred Interest*

The tax treatment of contingent deferred interest payments is of concern to both parties to a SAM. Probably because there has been confusion of SAMs with EPAs, some commentators have questioned whether lenders can treat the receipt of contingent deferred interest as a capital gain, rather than as interest, which is ordinary income,<sup>281</sup> and whether the borrower must treat the payment of deferred interest as a capital payment, rather than as a current expense in the form of interest.<sup>282</sup> In most situations, the parties will want characterizations that conflict. Lenders usually prefer capital gain treatment while borrowers usually benefit most by deducting the payments against ordinary income. If the payment is termed capital in nature, however, the borrower might benefit because the portion of profits paid to the lender would not be considered gain to the borrower. Also, although interest deductions are often more valuable to the borrower, the borrower might not have enough income to take full advantage of the deduction in the year of payment.

The FHLBB when considering proposed regulations concluded that appreciation received by a savings and loan association from a SAM would be ordinary income, not capital gain.<sup>283</sup> Additionally, the

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278. *See id.* § 441 (1976 & Supp. IV 1980).

279. *See id.* § 163(d) (1976 & Supp. IV 1980).

280. *See id.* § 483 (1976).

281. *See supra* note 275.

282. *Id.*

283. "The Board believes that the structure of the SAM will cause it to have tax consequences which differ significantly from those of other residential mortgage instruments. For example, the payment of contingent interest by a borrower on maturity or payment in full of the loan or sale or transfer of the property could result in an income tax deduction for the borrower in excess of his/her taxable income for the year. Any such excess deduction could be neither carried forward nor added to basis. In addition, contingent interest received from a borrower by a lender or secondary market purchaser of the SAM would be taxable income in the year it is received. Moreover, as contrasted to certain widely used non-residential mortgage arrangements involving equity participation by the lender, the portion of the appreciation received by an association on a SAM would constitute ordinary income, rather

California legislature structured the SAM as a loan and treated the parties as lender and borrower.<sup>284</sup> The IRS has not yet made a formal ruling.<sup>285</sup>

The conclusions of the FHLBB and the California legislature appear clearly correct for SAMs, and follow the assumption that an ordinary debtor-creditor relationship exists between the mortgagor and the mortgagee in a SAM. The contingent deferred interest provision in a SAM exists solely for the purpose of defining the amount and time of payment of a portion of the interest; its inclusion in the loan document does not change the interest obligation into something else. The parties to a SAM are nothing other than parties to a debtor-creditor relationship.<sup>286</sup> The lender has no equity ownership in the property. In view of the nature of the relationship, the characterization of contingent deferred interest as "interest" for purposes of section 163(a) of the I.R.C. is a result that follows by definition. It is also in accord with case law and Revenue Rulings.<sup>287</sup>

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than capital gain." 45 Fed. Reg. 66,801, 66,804 (1980). The quotation concerns only residential loans. Compare *infra* text accompanying note 291.

284. CAL. CIV. CODE § 1917.160 (West Supp. 1982).

285. The Internal Revenue Service acknowledges that it has received many questions concerning whether contingent deferred interest should be treated as ordinary income or capital gain. Wash. Post, Dec. 6, 1980, at F9, col. 1. See generally *supra* note 274.

286. See, e.g., *infra* text accompanying notes 379-92.

287. In *Dorzback v. Collison*, 195 F.2d 69 (3d Cir. 1952), a debtor/creditor relationship was amended to provide that, in lieu of interest at the rate of 5% per annum, the creditor would receive 25% of the net profits of the debtor's business. *Id.* at 70. The court quoted the United States Supreme Court in defining interest as being "the amount which one has contracted to pay for the use of borrowed money." *Id.* at 72 (quoting *Old Colony R.R. v. Commissioner*, 284 U.S. 552, 560 (1932)). The court also noted that payments made in lieu of interest were in fact to be treated as interest, and that it was not a requirement that interest be computed at a stated or fixed rate, but only that it be an ascertainable amount. *Id.* at 72 (quoting *Kena, Inc. v. Commissioner*, 44 B.T.A. 217, 219-20 (1941)). In *Kena*, the borrower and lender entered an agreement in which the borrower received a sum of money as a "loan"; the borrower agreed to repay the principal and to pay a further sum "in lieu of interest" equal to 80% of the net profits of the borrower's business. 44 B.T.A. 217-18. The lender had no power or authority over the operation of the business. *Id.* at 219. The court held that the agreement was one creating a relationship of creditor and debtor, and that the amount paid for the use of the borrowed money was interest. "It is not essential that interest be computed at a stated rate, but only that a sum definitely ascertainable shall be paid for the use of borrowed money . . ." *Id.* at 221.

In Rev. Rul. 76-413, 1976-2 C.B. 213, two parties entered a land development loan agreement and the borrower executed a note that provided for a fixed rate of interest plus additional contingent interest equal to the greater of 1.75% of the gross receipts or \$300 per acre from the sale of portions of the property. The ruling was that the contingent interest payments constituted "interest" and "interest on obligations secured by mortgages of real property" within the meaning of I.R.C. § 856(c). *Id.* at 214. In Rev. Rul. 72-2, 1972-1 C.B. 19, the amount of interest payable pursuant to a tuition deferment plan was based in part upon the amount of the former student's income at the time. Citing *Kena*, the ruling was

The parties to a transaction, upon weighing the respective benefits and detriments of each approach, may prefer to be co-owners, as in an EPA, or may prefer to be borrower and lender, as in a SAM.<sup>288</sup> It is critical, however, that the parties not attempt an amalgam of these two

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that such payments were fully deductible even though the amount of interest was not computed at a rigid stated rate.

Under different and peculiar facts, a different result was reached in *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960). In that case, one party had lent money in return for fixed interest plus 50% of the appreciation of the value of the property. The facts in that case make it clearly distinguishable from the situation in a SAM. In that case the "lender" appeared to have a direct equitable interest in the fee title to the property. For instance,

- 1) the "lender" could initiate proceedings which would result in the sale of the property to a third party. *Id.* at 703.

- 2) the agreement contained a buy/sell agreement in which *either* party could propose to buy out the other party, and the other party was required either to buy out the offeror or to sell to the offeror. *Id.*

- 3) the principal and fixed interest was payable at fixed times over a 10-year period, with a fixed maturity date at the end of the period. However, the "lender's" interest in the appreciation continued thereafter even though the principal had been repaid, and could be terminated only by a sale of the property pursuant to the provisions described immediately above in subparagraphs 1 and 2. *Id.* at 705. The situation was effectively similar to a partnership at will.

Because the facts of *Farley* are so different from those in a SAM, the case should not cause any apprehension for a SAM lender. Unfortunately, the case also contains language indicating that payments which are contingent, or unfixed, cannot be considered interest. *Id.* at 704-06. If this language is taken at face value, the case is clearly wrongly decided. Instead, the case should be narrowly construed, and limited to its own admittedly "complicated" facts. *Id.* at 702.

Three other authorities fall into the same category as *Farley* in that, although these authorities are clearly distinguishable from SAMs on their facts, they contain statements to the effect that the inclusion of contingent interest prevents a transaction from being a loan. *Portage Plastics Co. v. United States*, 301 F. Supp. 684 (W.D. Wis. 1969); *Gurtman v. Commissioner*, 34 T.C.M. (CCH) 475 (1975); Private Ruling 8140017 (June 30, 1981, available on LEXIS, Fedtax library, PR file). Among others, the following facts, which would not be present in a SAM, existed in one or more of the three authorities just cited, or in *Farley*: 1) the structuring of the transaction as a loan was for the apparent purpose of tax avoidance, 2) the structuring of the transaction as a loan occurred in situations where typically a loan structure would not have been used, 3) the purported lender had some effective control over the property or business exceeding that which a lender ordinarily would have and exceeding that which would be justifiable for purposes of protecting the security), 4) there was no written evidence of the debt obligation, 5) the payment of all interest was subject to a profit contingency, 6) there was no fixed time schedule for repayment of interest or principal, 7) there was no security for the debt, 8) the profits in question were to be generated by a business enterprise of some sort, 9) there was a provision by which the purported lender was obligated to subordinate to some or all of the borrower's future creditors, 10) there was a high ratio of debt to equity, 11) there was no provision for acceleration of principal in the case of default, 12) all of the purported lender's anticipated returns were speculative in nature.

288. See *supra* text accompanying notes 26-27.

incompatible structures. If the SAM structure is used, the payment should be treated as an interest payment by both borrower and lender.

*Year of Inclusion or Deduction of Contingent Deferred Interest*

If contingent deferred interest is deemed received and paid in the year the cash is actually paid to the lender, both lender and borrower may receive unfavorable tax treatment. The borrower may not be able to take full advantage of the interest tax deductions if the amount of contingent interest paid comprises a large percentage of the taxpayer's income.<sup>289</sup> The lender, on the other hand, may be pushed into a higher tax bracket by receipt of this large amount of ordinary income.

The FHLBB, when commenting on its proposed SAM regulations, elaborated on this question. It noted that the deduction for contingent deferred interest would probably have to be taken all in one year, possibly in an amount larger than the taxpayer's income.<sup>290</sup> Furthermore, unless the interest expense relates to property used in a trade or business allowing it to be carried forward as a net operating loss,<sup>291</sup> the deduction could neither be carried forward nor added to basis.<sup>292</sup> A similar result would occur for the lender.<sup>293</sup> Other analyses of the problem, unfortunately, lead to the same result.<sup>294</sup>

The year contingent deferred interest is includible or deductible does not depend upon whether the taxpayer reports on an accrual or cash basis. A cash-basis taxpayer can deduct interest payments only when actually paid.<sup>295</sup> Similarly, a lender reporting on the cash basis

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289. I.R.C. § 163 (1976). Even if contingent deferred interest payments are fully deductible in the year paid (i.e., not in excess of taxable income after other deductions are taken), there are two reasons why the deduction will be worth less to the borrower than it would have been had the deduction been spread out over the term of the loan. First, the tax savings benefit of the deduction will have been deferred to a later taxable year. Second, a large deduction in one year will push the borrower into a lower tax bracket and, therefore, a portion of the deduction will be less advantageous to the borrower because it will offset income which is being taxed at a lower rate.

290. See *supra* note 283.

291. I.R.C. § 172 (1976 & Supp. IV 1980).

292. The net operating loss provision is limited to trade or business deductions. *Id.* The item cannot be carried forward as a long-term capital loss because it is a deduction item, not a capital loss. See *supra* text accompanying notes 281-88. Similarly, the payment cannot be added to basis. *Id.*; I.R.C. § 1016(a)(1) (1976).

293. The lender cannot report the interest as income until received. See *infra* text accompanying notes 296-98. Of course, once received, it must all be reported as income and not deferred.

294. Angell & Wardrep, *supra* note 231, at 39; Kmiec, *supra* note 81, at 316; Levine, *supra* note 75.

295. I.R.C. § 7701(a)(25) (1976); Treas. Reg. § 1.461-1(a)(1) (1982); see *Helvering v.*

will not report accrued interest income until received.<sup>296</sup> The fact that the interest obligation is contingent and deferred does not affect its treatment for cash-basis taxpayers. Once payment occurs, both the contingent and deferred aspects disappear.<sup>297</sup>

Similar results occur with respect to accrual taxpayers. Technically, payment of income accrues when the contingency is removed, not when payment is made. In a SAM, however, removal of the contingency (i.e., determination of profits) usually occurs simultaneously with actual payment. Until then, the existence of the contingency prevents accrual for both borrower and lender because neither the fact of liability nor the amount of payment are known.<sup>298</sup>

The year of tax treatment of the contingent deferred interest portion of SAMs is further illuminated by analogy to the Service's tax treatment of graduated payment mortgages. Revenue Ruling 77-135<sup>299</sup> states that under the cash method of accounting, interest due under a graduated payment mortgage plan is includible in the mortgagee's income for the taxable year in which it is actually or constructively received, and is deductible by the mortgagor in the year paid. The addition of unpaid interest to the note, a requirement in the early years of a graduated payment mortgage, does not constitute a payment or receipt of interest in that year.<sup>300</sup>

Under the accrual method of accounting, interest from a graduated payment mortgage plan is includible in the mortgagee's gross income in the taxable year in which the mortgagee acquires a fixed right to receive the interest; it is deductible by the mortgagor in the taxable

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Price, 309 U.S. 409 (1940); *Mitchell v. Commissioner*, 42 T.C. 953, 969 (1964); *Christensen v. Commissioner*, 40 T.C. 563, 577-78 (1963).

296. Treas. Reg. § 1.446-1(c)(1)(i) (1957).

297. Of course, taxpayers cannot deduct prepaid interest. I.R.C. § 461(g) (1976). However, the term "prepaid interest" applies only to interest which "is properly allocable to any period . . . which is after the close of the taxable year in which paid." *Id.* Thus if a SAM borrower, on the fifth anniversary of its loan, voluntarily prepays five years of accumulated contingent deferred interest, the borrower may deduct it all in that year. In short, the prohibition on deduction of prepaid interest relates only to interest paid with respect to a future period, not interest which has accrued but is not yet due. The foregoing assumes that, if a prepayment occurs, the borrower is not entitled to a refund if the property later depreciates.

298. Treas. Reg. § 1.461-1(a)(2) (1964); Treas. Reg. § 1.446-1(c)(1)(ii), T.D. 7285, 1973-2 C.B. 163, 164; Rev. Rul. 77-110, 1977-1 C.B. 58; *see also* *Jones Lumber Co. v. Commissioner*, 404 F.2d 764 (6th Cir. 1968); *Burlington-Rock Island R.R. Co. v. United States*, 321 F.2d 817 (5th Cir. 1963); *Pierce Estates, Inc. v. Commissioner*, 195 F.2d 475 (3d Cir. 1952); *George L. Castner Co. v. Commissioner*, 30 T.C. 1061 (1958); *Holtzman v. Commissioner*, 35 T.C.M. (CCH) 1088 (1976).

299. Rev. Rul. 77-135, 1977-1 C.B. 133.

300. *Id.*

year in which the liability is determined. Because the graduated payment mortgage plan described in Revenue Ruling 77-135 accrues interest at a fixed rate per annum on the unpaid mortgage balance, the mortgagee acquires a fixed right to receive a specific amount of interest and includes the amount accrued in gross income in the taxable year accrued, even though the interest might not be received in that year. The mortgagor, similarly, may deduct a corresponding amount even though the interest may not be paid until a later year.<sup>301</sup> If the logic of Revenue Ruling 77-135 is applied to SAMs, however, the contingent deferred interest element could not be taken into account prior to maturity because the liability and amount are not yet fixed.<sup>302</sup>

Finally, section 483 of the Internal Revenue Code, as it applies to SAMs, also implies that contingent deferred interest is reportable only when paid. Section 483 may affect certain loans that carry a fixed interest rate of less than nine percent.<sup>303</sup> Regulations under this section provide detailed rules for treatment of these loans if a portion of the interest is contingent.<sup>304</sup> Interest is deemed contingent if the liability for, or the amount or due date of, such interest cannot be determined at the time of the sale or exchange.<sup>305</sup> If a loan that is subject to section 483 also provides for contingent interest, the contingent interest is ignored for purposes of determining whether interest must be imputed,<sup>306</sup> the necessary implication is that contingent interest is to be reported not currently, but when actually paid.

### *Spreading the Interest Deduction Over Multiple Years*

The unfavorable tax results to both borrower and lender from reporting income in the year the contingent interest is actually paid raise

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301. *Id.*; see also Davis, *The Tax Aspects of Graduated Payment Mortgages*, 9 MORTGAGE BANKER, 40, 42 (Feb. 1979).

302. Kmiec, *supra* note 81, also concluded that accrual lenders cannot avoid the harsh consequences of receipt of contingent deferred interest in a single year. Kmiec stated: "Four methods of income recognition seem possible under the accrual method: (1) upon payment, (2) annually based upon the difference between the market interest rate and the SAM's below-market rate, (3) annually based upon a housing inflation index, or (4) annually based upon actual appraisal. Only the first method seems realistic, and the FHLBB has so indicated in its proposed regulations. While the three other methods are valid in theory, all involve the creation of tax liability prior to the receipt of income. Given the precarious financial condition of mortgage lenders in today's high interest market, few lenders would support accounting practices which, at best, improve current paper earnings." *Id.* at 317.

303. See *infra* text accompanying notes 314-18.

304. Treas. Reg. § 1.483-1(e)(2), (3) (1966), as amended by T.D. 7781, 1981-2 C.B. 118, 123 and by T.D. 7394, 1976-1 C.B. 135, 138.

305. *Id.*

306. *Id.*



a third question: Can the borrower spread the interest deduction over more than one year so as to maximize the benefits?<sup>307</sup> One possible solution is to structure the SAM note to permit the borrower to make periodic prepayments of contingent deferred interest. If a borrower desires to make payments of contingent deferred interest at particular times, such payments would be permitted by appraisal procedures written into the note. Alternatively, periodic payments of deferred interest could be required in a SAM note.<sup>308</sup> Unfortunately, many borrowers are unable financially to exercise this option because they would be able to make contingent deferred interest payments only upon realizing the increased value of the property.

If the parties report their income taxes on a cash, rather than on an accrual, basis, a second approach is to permit the borrower to pay the contingent deferred interest over multiple years following the sale of the property or maturity of the note. The debt to the lender would be evidenced by a promissory note, possibly secured by a certificate of deposit, letter of credit, or similar item purchased by the borrower with the portion of the sale proceeds that would otherwise be payable to the lender as deferred interest upon sale of the property.

Tax court decisions support this approach. In *Franklin v. Commissioner*,<sup>309</sup> the Tax Court denied deductions to a taxpayer for interest payments purportedly made by the issuance of promissory notes, because the taxpayer did not part with cash or its equivalent at that time. *Franklin* is consistent with prior decisions disallowing deductions claimed with respect to issuance of promissory notes.<sup>310</sup> These decisions indicate that interest payments made by a cash-basis taxpayer by the issuance of promissory notes are deductible only in the year the actual cash payment on the note is made. The fact that the note is secured by a letter of credit should not, if the letter of credit is in

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307. If the borrower is "cashing out" so that all profits of sale will be taxed in the year of sale, then the borrower may or may not wish to utilize all of the interest deduction in that year, depending on the amount of taxable gain and the amount of contingent deferred interest. If a borrower is executing a § 1031 tax-free exchange, or is selling a residence intending to repurchase a residence under the tax deferral procedures of § 1034 of the Internal Revenue Code, then the borrower may wish to spread out the interest deduction over a period of several years.

308. See *supra* note 297.

309. 77 T.C. 173 (1981).

310. See, e.g., *Helvering v. Price*, 309 U.S. 409 (1940); *Hart v. Commissioner*, 54 F.2d 848 (1st Cir. 1932); *Heyman v. Commissioner*, 70 T.C. 482, 485 (1978); *San Diego Trust & Sav. Bank v. United States*, 71-2 U.S. Tax Cas. (CCH) ¶ 9518 (1971); *England v. Commissioner*, 34 T.C. 617 (1960); Rev. Rul. 70-647, 1970-2 C.B. 38; *Thomason v. Commissioner*, 33 B.T.A. 576 (1935).

standby form, change the result.<sup>311</sup>

### *Interest Limitation Rules*

I.R.C. section 163(d)<sup>312</sup> creates a fourth tax issue for certain SAM borrowers by limiting the amount of interest otherwise deductible under the Code. Section 163(d), however, applies only to investment interest of noncorporate taxpayers.<sup>313</sup> Thus, borrowers obtaining SAMs to purchase principal residences are exempt from this limitation. Similarly, commercial corporate borrowers are unaffected. Only noncorporate SAM borrowers purchasing investment property are subject to this limitation. Those borrowers so affected may avoid the problem by spreading the deduction over multiple years, as discussed above.

### *Imputed Interest Rules*

The final tax issue arising from SAMs stems from the imputed interest rules of I.R.C. section 483. Under section 483, SAMs with fixed interest rates of nine percent or less shall be imputed as bearing interest at ten percent.<sup>314</sup> As a result, SAM lenders may be obligated to report additional ordinary income in the amount of unstated interest calculated under section 483 before the contingent deferred interest is actually received.<sup>315</sup>

Three qualifications temper the effects of this section. First, section 483 applies only to contracts for the sale or exchange of property.<sup>316</sup> Thus, only SAMs entered into between a buyer and a seller of real property are subject to the imputed interest rule. Second, the regulations provide for the recalculation of the imputed interest upon actual payment of contingent interest.<sup>317</sup> As a result, when the contingent deferred interest is received, a lender is able to exclude from ordinary income the full amount of interest imputed and included in income in

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311. Treas. Reg. § 15A.453-1(b)(3)(iii) (1981) (temporary).

312. I.R.C. § 163(d) (1976).

313. *Id.* § 163(d)(1). Investment interest is that "paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." *Id.* § 163(d)(3)(D).

314. *Id.* § 483 (1976).

315. Although payment of contingent deferred interest upon sale of the property or maturity of the SAM will usually render the effective interest rate higher than nine percent, "no part of such contingent interest shall be taken into account for purposes of section 483 until it is actually paid." Treas. Reg. § 1.483-1(e)(2) (1966).

316. I.R.C. § 483(a) (1976).

317. The regulations set forth at Treas. Reg. § 1.483-1(e)(2) provide that subparagraph (f) of § 1.483-1 of the regulations shall be used to compute payments of unstated interest in situations similar to SAMs. Treas. Reg. § 1.483-1(f)(4)(ii) sets forth the appropriate calculation.

prior taxable years. Likewise, if the borrower has previously deducted payments of unpaid interest, an equal amount of the payment of contingent deferred interest must be excluded from the interest deduction. Finally, if lenders and borrowers wish to avoid the application of section 483 entirely, they may establish a fixed interest rate higher than nine percent, or make the SAM payable in interest-only payments.<sup>318</sup>

It is clear from the foregoing analysis that SAMs can produce adverse tax results for both borrowers and lenders. Structuring of the loan with these issues in mind will, however, avoid most tax problems for both parties.

### Securities Law

SAM lenders and borrowers must consider whether a SAM is a "security" for purposes of both federal and applicable state securities laws.<sup>319</sup> If a SAM were deemed a security for federal securities law purposes there would be some unusual and dramatic consequences. Federal securities laws, for example, prohibit the offer or sale of a "security" without registration, unless the security is exempt or is sold in an exempt transaction.<sup>320</sup> If a SAM is a "security" under federal law, the SAM borrower is required to register the SAM unless there is an applicable exemption.

A second important consequence of deeming a SAM a security is the applicability of the antifraud provisions of the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act").<sup>321</sup> If applicable to SAMs, the lender can rely on the broad antifraud remedies of those statutes even if the SAM is exempt from the registration requirements.<sup>322</sup>

Determining whether a particular transaction or scheme is a security for federal securities laws purposes is a complex issue. Section 2(1)

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318. If the monthly payments are interest only, there will be no principal payments which may be treated as imputed interest payments. I.R.C. § 483(a) (1976).

319. Although this discussion focuses exclusively on the federal securities law question, it is generally applicable to the treatment SAMs will receive under California state securities law. For the most part, if an arrangement is a security for federal purposes, it is also a security under California law. California Corporations Code § 25019 defines "security" in almost the same terms as § 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1976). Moreover, certain of the California registration exemptions which would generally be used for SAMs relating to nonpublic sales are essentially identical to federal exemptions. See CAL. CORP. CODE § 25102(f) (West 1977). See also *People v. Park*, 87 Cal. App. 3d 550, 563, 151 Cal. Rptr. 146, 152 (1978).

320. 15 U.S.C. §§ 77d-77e (1976 & Supp. IV 1980).

321. *Id.* §§ 77q and 78j (1976).

322. *Sohns v. Dahl*, 392 F. Supp. 1208 (W.D. Va. 1975).

of the 1933 Act defines "security" as including not only traditional types of securities, such as stocks and bonds, but also any "note," "investment contract," or "profit-sharing agreement."<sup>323</sup> The same terms are used in the 1934 Act.<sup>324</sup> Arguably, a SAM may be deemed a security under any one of these terms. This section of the Article will discuss each of these separately.

### Notes

Because SAMs are clearly notes, they appear at first glance to be securities under the 1933 Act and 1934 Act. Indeed, any bank loan evidenced by a note would be a security under a literal reading of the definition, which defines security to include any note.<sup>325</sup> The Second Circuit has tended to a literal reading of the two acts such that most notes would be deemed to be securities.<sup>326</sup> This approach has been rejected by other circuits.<sup>327</sup> The Second Circuit's literal approach has caused its decision to be reversed by the United States Supreme Court in a case addressing the question whether shares in a cooperative apartment corporation are securities.<sup>328</sup> Nevertheless, the Second Circuit has persisted with the literal approach.<sup>329</sup> That court has indicated that "the note secured by a mortgage on a home" is not a note within the meaning of the federal securities laws.<sup>330</sup> However, assuming the court had in mind the then-typical thirty-year fixed rate mortgage, it is not clear that a SAM would be so treated by that court. All that can be said is that the Second Circuit's analysis would deem a SAM not to be a security only if SAMs "bear a strong family resemblance" to the home financing devices in use when the court made that statement in 1976, i.e., if the "context" of the transaction is the same.<sup>331</sup> Though a SAM differs from a more traditional note in that it bases a part of the interest return on a contingency, the SAM is nevertheless being issued in the same "context" and thus presumably a residential SAM would

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323. 15 U.S.C. § 77b(1) (1976).

324. *Id.* § 78c(a)(10) (1976).

325. There are some express exemptions for certain notes with terms of nine months or less. *Id.* §§ 77c(a)(3), 78c(a)(10) (1976).

326. *See, e.g.,* Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976).

327. *E.g.,* Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982).

328. Forman v. Community Servs., Inc., 500 F.2d 1246 (2d Cir. 1974), *rev'd sub nom.* United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975).

329. Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982) (sale of 100% of stock of company held to constitute sale of security even though buyer would control company and thus would not rely on management by a third party).

330. 544 F.2d at 1138.

331. *Id.*

bear such resemblance. Absent extraordinary facts, a commercial SAM should also.

A number of other courts have seized upon the prefatory words of section 2(1) of the 1933 Act,<sup>332</sup> "unless the context otherwise requires," as the basis for differentiating between commercial notes, which are not securities, and investment notes, which are.<sup>333</sup> The United States Supreme Court has approved the practice of looking to the economic realities of the individual transaction.<sup>334</sup> More recently, in a decision perhaps boding ill for the Second Circuit's literal approach, the United States Supreme Court approved looking to the prefatory words quoted above so as to limit the applicability of the acts to "instruments ordinarily and commonly considered to be securities in the commercial world."<sup>335</sup>

There are two tests applied by the courts (other than the Second Circuit, which follows the literal approach) to distinguish commercial notes from investment notes. The Third, Fifth, Seventh and Tenth Circuits rely on the commercial-investment dichotomy theory<sup>336</sup> and the Ninth Circuit uses the risk-capital test.<sup>337</sup> Generally, under these tests only those notes in the nature of an investment are treated as securities; a note involved in a commercial transaction would not be a security. The distinction between investment notes and commercial notes under either test is vague, for "[i]n one sense every lender of money is an investor since he places his money at risk in anticipation of a profit in the form of interest."<sup>338</sup> The two tests appear, however, to yield similar results.

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332. 15 U.S.C. § 77b (1976). Identical words appear in the 1934 Act. *Id.* § 78c(a) (1976).

333. *See, e.g.,* National Bank of Commerce of Dallas v. All Am. Assurance Co., 583 F.2d 1295 (5th Cir. 1978); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

334. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849-51 (1975). "With the exception of the Second Circuit, every Court of Appeals recently to consider the issue has rejected the literal approach . . . ." *Id.* at 849 n.14.

335. Marine Bank v. Weaver, 102 S. Ct. 1220, 1225 (1982) (bank certificate of deposit not a security).

336. *See, e.g.,* Emisco Indus. v. Pro's, Inc., 543 F.2d 38 (7th Cir. 1976); Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973).

337. Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d 426 (9th Cir. 1978); United Cal. Bank v. THC Fin. Corp., 557 F.2d 1351 (9th Cir. 1977); Great Western Bank & Trust Co. v. Kotz, 532 F.2d 1252 (9th Cir. 1976). *See generally* Lipman, *Notes as Securities*, 14 REV. SEC. REG. 933 (1981).

338. C.N.S. Enters. v. G. & G. Enters., 508 F.2d 1354, 1359 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).

The "investment-commercial" test is based on the view that securities laws are not designed to regulate commercial transactions. The courts applying this test focus on several characteristics of the transaction in determining whether its primary character is investment or commercial. For example, the Third Circuit has held that promissory notes given by a licensee in payment for the purchase of franchise sale center licensing agreements are not securities within the meaning of the federal laws because the notes were personal, were not publicly offered, were not procured for speculation or investment and did not solicit venture capital.<sup>339</sup>

The Fifth Circuit has also ruled that a one-year promissory note issued for a bank loan was not a security when the proceeds were used to pay the general corporate obligations of a closely-held corporation.<sup>340</sup> Analyzing the prior federal decisions, the court stated:

The cases excluding certain notes from the coverage of the [1934] Act generally involved underlying transactions between payor and payee which were not of an investment nature. . . .

On the other hand, where notes have been deemed securities within the meaning of the securities laws, either of two factors, not present here, usually indicated the investment overtones of the underlying transactions. [The notes were either] offered to some class of investors, [or] were . . . acquired . . . for speculation or investment . . . [or the borrower obtained] investment assets, directly or indirectly, in exchange for its notes.<sup>341</sup>

Since neither factor was present in that case, the court held that the note was not a security.<sup>342</sup>

The Ninth Circuit's "risk capital" test, established in *Great West-*

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339. *Lino v. City Inv. Co.*, 487 F.2d 689, 694-95 (3d Cir. 1973). A recent lower court decision in the Third Circuit held that a promissory note given to evidence a simple commercial loan, used to purchase a condominium, was not a security. *Rispo v. Spring Lake Mews, Inc.*, 485 F. Supp. 462, 466 (E.D. Pa. 1980). See also *infra* text accompanying notes 360-61. Thus, the court concluded that, in the context of a commercial loan, the promissory note could not be construed to be a security. The Seventh Circuit has taken a similar approach and held that where "promissory notes were of a 'commercial' rather than 'investment' character . . . [they] were not 'securities' under the 1933 Act or 1934 Act." *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038, 1040 (7th Cir. 1979).

340. *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

341. *Id.* at 493-94 (footnote omitted).

342. *Id.*; see also *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295 (5th Cir. 1978), where a \$2.5 million note issued to a bank was not a security since no special investment rights were given to the payee; the note was payable in fixed amounts at fixed times, and the bank anticipated no gain beyond repayment of the note with interest. In *Bellah v. First Nat'l Bank*, 495 F.2d 1109 (5th Cir. 1974), a promissory note of six-month maturity issued for a bank loan needed to aid the borrowers in the development of their livestock business was commercial paper and, therefore, not a security.

*ern Bank & Trust Co. v. Kotz*,<sup>343</sup> considers six factors in measuring the risk involved to the lender in determining whether a note is a security. These factors include the term of the note;<sup>344</sup> the extent of collateralization;<sup>345</sup> the form of the obligation;<sup>346</sup> the circumstances of issuance;<sup>347</sup> the relationship between amount borrowed and the size of the borrower's business;<sup>348</sup> and the contemplated use of the proceeds.<sup>349</sup>

The leading Ninth Circuit cases have balanced these factors to determine whether certain notes are to be characterized as securities.<sup>350</sup> In the *Great Western Bank & Trust* case, the court held that an unsecured promissory note delivered to a bank in consideration of the extension of a \$1.5 million line of credit did not constitute a security.<sup>351</sup> The instrument had a maturity of ten months, bore interest at a rate slightly higher than the prime rate, limited the use of proceeds to working capital only, thereby excluding capital expenditures, obligated the borrower to maintain a checking account balance of \$300,000 with the bank, allowed the bank to inspect the borrower's property and records, and set forth numerous events of default entitling the lender to accelerate the loan.<sup>352</sup> The economic realities of the transaction indicated that the risk created was commensurate with the risk normally associated with lending money for a period of time.<sup>353</sup>

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343. 532 F.2d 1252 (9th Cir. 1976).

344. Time is considered the most important factor because the longer one's funds are used by another, the greater the risk of loss. "A demand or short-term note is almost *ipso facto* not a security." *Id.* at 1257.

345. "The unsecured lender is generally more dependent upon the managerial skills of the borrower than is a secured party who can look to the collateral in case of inability to repay." *Id.* at 1258 (footnote omitted).

346. This factor is utilized to help explain the fourth factor, the circumstances of issuance. *Id.*

347. "Whether the obligations were issued to a single party or to a large class of investors sheds light on the nature of the financing." *Id.*

348. "[T]he larger the relative amount, the greater the stake, and therefore the risk, of the lender." *Id.*

349. "Proceeds constituting an essential ingredient of enterprise formation . . . are generally securities [but] those used to maintain current financial position generally are not." *Id.*

350. *Brodt v. Bache & Co.*, 595 F.2d 459 (9th Cir. 1978); *Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc.*, 583 F.2d 426 (9th Cir. 1978); *United Cal. Bank v. THC Fin. Corp.*, 557 F.2d 1351 (9th Cir. 1977).

351. 532 F.2d at 1260.

352. *Id.* at 1254-55.

353. *Id.* at 1259. *See also* *United Cal. Bank v. THC Fin. Corp.*, 557 F.2d 1351 (9th Cir. 1977) (A "put letter" agreement in which a financial thrift company agreed to purchase for six months all notes taken by a bank to secure debts under a line of credit extended to one of its creditors did not constitute a security.) The concurring opinion in *Great Western Bank & Trust* suggests that part of the reason for the decision is that courts are loathe to find bank

In *Amfac Mortgage Corp.*,<sup>354</sup> the court found that a construction loan was made in the course of an ordinary commercial financing transaction and, therefore, was not a security.<sup>355</sup> The court applied the six factors of the risk-capital test and emphasized the short two-year term of the note, the form of the documentation, the presence of extensive collateralization, the specification of default events, and circumstances indicating that the investor was not risking its money on the borrower's efforts.<sup>356</sup>

The Ninth Circuit cases indicate that there is little difference in result between the commercial-investment dichotomy theory and the risk-capital test. Under each test the primary concern is the degree of risk to the lender or investor as reflected in the nature and structure of the transaction. A lender expects a specific return on its investment (the specific return may be fixed or may vary according to prime rate, property appreciation, or other factors), whereas an investor assumes that the investment is subject to some degree of risk. The tests are difficult to apply, however, because courts have used a wide range of characteristics to determine whether the particular transaction is a security.

No federal cases to date have analyzed whether a note secured by real property and containing a contingent interest element is a security under either the risk-capital test or the commercial-investment dichotomy theory. Whether SAMs are securities must therefore be assessed in light of the inconclusive case law that exists. The question is further complicated by the varied terms and character of individual SAMs. However, it can be predicted that under both the primary intent and specific considerations of these two tests, most SAMs should not be deemed securities.

Under both the risk-capital and commercial-investment dichotomy theories, the cases seem to be concerned with whether a note represents an investment of capital with the return based on the managerial efforts of others and with the extent of risk or uncertainty. In a SAM, the lender's profits result not from the efforts of others, but, in most cases, from the property's appreciation due to independent forces such as inflation and increase in population pressures. The im-

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loans to be securities. 532 F.2d at 1260-62. This presumably results not from any exemption from the securities laws that bank borrowers have, but from the nature of bank loans. Accordingly, the result should be the same for a commercial or real estate loan from any institutional lender, whether or not a bank, or even from a noninstitutional lender fulfilling an essentially similar role on generally the same terms.

354. 583 F.2d 426 (9th Cir. 1978).

355. *Id.* at 434.

356. *Id.* at 432-34.



provement and regular upkeep of a home by a residential SAM borrower, or the operation of business property by a commercial SAM borrower, will have little, if any, direct effect on the lender's yield. Also, the risk of return of principal and fixed interest is slight. The risk with respect to the contingent deferred interest should not change this result. Thus, SAMs are more similar in nature to commercial notes than to notes representing an investment of risk capital.

Further, under five of the six factors<sup>357</sup> used in the risk-capital test, SAMs are not securities. First, under the extent-of-collateralization test, SAMs are secured by real property. Under the third factor—the terms and form of the obligation—the documentation evidencing a SAM normally more closely resembles traditional commercial transactions than securities. Under the fourth factor, the circumstances of issuance, SAMs involve only a single lender and a single borrower. Under the fifth factor, the relationship between size of loan and size of business will vary from one SAM to another. However, it appears that this test is of limited importance where the basis for the loan is not primarily the financial wealth of the borrower, but the value of the collateral.<sup>358</sup> Finally, SAMs will not be used for the formation of a business enterprise and so do not meet the sixth test for securities, the contemplated use of proceeds.

Two characteristics do support a finding that SAMs are securities. First, the Ninth Circuit's risk-capital test considers the term of the note as a factor in determining whether a note is a security, reasoning that the longer one's funds are used by another, the greater the risk of loss.<sup>359</sup> In some SAM situations, the term will be twenty to thirty years. This factor is not enough to support the conclusion that a SAM is a security, however, because traditional mortgage loans are normally thirty-year term notes, and such notes are ipso facto not securities.

Another characteristic suggesting that SAMs may be securities is the lack of a fixed interest rate. In *Rispo v. Spring Lake Mews, Inc.*, the court determined that the note was not a security relying on the fact that the interest rate of the note was fixed.<sup>360</sup> There is no reason to believe, however, that other common alternatives to fixed-rate mortgages, such as renegotiable rate, variable rate, and graduated payment

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357. See *supra* notes 344-49 & accompanying text.

358. See *C.N.S. Enters. v. G. & G. Enters.*, 508 F.2d 1354, 1361 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).

359. *Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc.*, 583 F.2d 426, 432 (9th Cir. 1978).

360. 485 F. Supp. 462, 466 (E.D. Pa. 1980).

rate mortgages, are securities. Similarly, a note with a rate fixed at, for example, two points above the bank prime rate, as from time to time in effect, would undoubtedly not be deemed a security solely because the rate may fluctuate. *Rispo* should be read to mean that the lack of a fixed rate is important only if the amount of the unfixed return will eventually be determined by the entrepreneurial or managerial efforts of others.<sup>361</sup> Because the appreciation of SAM-encumbered property will typically not depend on the efforts of the owner, but rather on general market conditions, and carries no greater risk of return of principal than traditional mortgage loans, it appears that SAMs, absent unusual facts, should not be found to be securities under either the commercial-investment dichotomy theory or the risk-capital test.

### *Investment Contracts*

The United States Supreme Court formulated the standard for determining whether an investment arrangement constitutes an investment contract, and thus a security, in *SEC v. W.J. Howey Co.*<sup>362</sup> Under the *Howey* test, a security exists whenever (1) an investment of money is made, (2) in a common enterprise, (3) with an expectation of profits produced solely from the efforts of others. In *Howey*, investors' funds were pooled and used to purchase undivided fractional interests in citrus trees. The investors were offered management contracts for the growing, harvesting, and sale of the fruit produced. The arrangement was held to be an investment contract.<sup>363</sup>

The Ninth Circuit defined a "common enterprise," the second element of the *Howey* test, as one in which the "fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."<sup>364</sup> This concept, which has been referred to as "vertical commonality," dictates that the common enterprise element is satisfied when the investor and the promoter are involved in some common venture, even if other investors are not involved in the venture.<sup>365</sup> The profit feature of a SAM does

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361. See *supra* note 339.

362. 328 U.S. 293 (1946).

363. *Id.* at 301.

364. *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 n.7 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

365. *Brodt v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978). Vertical commonality has not been adopted in other circuits where the test of horizontal commonality is applied (i.e., there must be more than one investor). SAMs with only a single lender would not meet this test. Compare *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974), with *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96 (7th Cir. 1977).

not depend upon the lender and the borrower engaging in a "common venture" because the "fortunes" of the lender are not "interwoven with and dependent upon the efforts and success" of the borrower.<sup>366</sup>

The third element of the *Howey* test requires that the investor's expected profits come solely from the efforts of others. The Ninth Circuit glossed this requirement in *SEC v. Glenn W. Turner Enterprises*,<sup>367</sup> by holding that the critical inquiry is whether the efforts made by those other than the investor "are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."<sup>368</sup> An investment contract may therefore exist even though there is some participation by the investor in the enterprise.

Numerous cases have discussed the contours of the third element of the *Howey* test.<sup>369</sup> The focus of these cases is similar to the analyses in the note cases.<sup>370</sup> Therefore, because the lender's return in a SAM usually does not depend upon the managerial efforts of either the borrower or a third party, a SAM should not be deemed an investment contract.<sup>371</sup>

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366. See *supra* text accompanying note 364.

367. 474 F.2d 476, 481-82 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

368. *Id.* at 482.

369. See, e.g., *Goodman v. Epstein*, 582 F.2d 388 (7th Cir. 1978); *McCown v. Heidler*, 527 F.2d 204 (10th Cir. 1975); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974); *Nash & Assoes. v. Lum's of Ohio, Inc.*, 484 F.2d 392 (6th Cir. 1973).

370. See cases cited *supra* notes 325-61.

371. As Professor Loss has stated: "For example, no 'investment contract' is involved when a person invests in real estate, with the hope perhaps of earning a profit as the result of a general increase in values concurrent with the development of the neighborhood, as long as he does not do so as part of an enterprise whereby it is expressly or impliedly understood that the property will be developed or operated by others." 1 L. LOSS, *SECURITIES REGULATION* 491-92 (2d ed. 1961) (footnote omitted). The question whether SAMs are securities is analogous to the question of whether the sale of commodity futures is the sale of a security. The law is clear that the sale of commodities futures, without more, is not the sale of a security. *E. F. Hutton v. Lewis*, 410 F. Supp. 416, 418 (E.D. Mich. 1976). Although there are two rationales for so concluding, both hinge on the failure of such transactions to meet the three-prong *Howey* test. The first rationale is that the second-prong common enterprise test cannot be met because of a lack of horizontal commonality, see *supra* note 365, or because the "fortunes" of the broker (whose income is based on commissions) and of the investor (whose income depends on the investment) are not "interwoven," see *supra* text accompanying note 364. Compare *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96 (7th Cir. 1977), with *Brodt v. Bache & Co.*, 595 F.2d 459 (9th Cir. 1978). This rationale may not be sufficient to exempt SAMs. The second rationale, however, is that in nondiscretionary trading accounts for commodities futures the results of the investment do not depend on the managerial efforts of the broker. As a result, the factual situation does not satisfy either the third prong of the *Howey* test (quoted *supra* text accompanying note 368) or the second

*Profit-Sharing Agreements*

There have been remarkably few cases discussing the meaning of the phrase "certificate of interest or participation in any profit-sharing agreement" as used in section 2(1) of the 1933 Act.<sup>372</sup> Thus, it is not easy to determine whether a particular scheme is a profit-sharing agreement and thus a security.

The courts that have considered the meaning of the phrase "profit-sharing agreement" have suggested that it is similar, if not identical, to

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prong as refined by *Glenn W. Turner* (quoted *supra* text accompanying note 364, requiring the fortunes of the investor to be "dependent" upon the efforts of others).

As stated in one case: "Moreover, the purchase of commodities futures involves no reliance upon the efforts of promoters, managers, employees or any third party. The mere presence of a speculative motive on the part of the purchaser or seller does not evidence the existence of an 'investment contract' within the meaning of the securities acts. In a sense anyone who buys or sells a horse or an automobile hopes to realize a profitable 'investment.' But the expected return is not contingent upon the continuing efforts of another." *Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966). It is true that, unlike a commodities broker, a SAM borrower is the owner of the investment. However, that does not mean that the SAM borrower has any significant control over the amount of appreciation the property will have.

In one "no-action" letter, the SEC staff found that a shared equity program was not an investment contract. The lender and borrower took title to residential property as tenants in common, agreeing to share the expenses of the purchase and the costs of property maintenance, and to divide the equity at the time of sale according to the respective ownership shares. The two parties made all decisions regarding how equity, mortgage payments, repairs and improvements, maintenance expenses, taxes, depreciation and rent were to be divided between them. The agreement also specifically provided that the two parties would regularly consult each other regarding these matters, and mutual consent was required in each instance. Moreover, the two parties were to determine together in advance when the property was to be sold, although, by mutual consent, this date could later be advanced or extended.

In this arrangement, it was clear that the expectation of profit derived from the common enterprise. The author of the letter argued that "[b]ecause in the shared equity arrangement the investor has complete control over his investment and full right to participate directly in the management of his property . . . a security [did] not exist." The SEC staff agreed.

A shared equity or equity participation arrangement is distinguishable from most SAMs. As is clear from the description of the above arrangement, there was equal involvement in the actual management of the property in that shared equity arrangement. It is true that the lender in a SAM is not involved in the management of the property. However, this should not make a SAM a security because the expectation of profits does not usually derive from the management efforts of the owner or of third parties, and because the return of principal and fixed interest is relatively risk-free. In certain cases, such as properties being developed by the proceeds of a SAM loan, the management efforts may be sufficiently important as to cause a different outcome.

372. *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974). "The parameters of the phrase 'commonly known as a security,' like those of the phrase 'interest in a profit sharing arrangement' are largely unrefined in federal law." *Id.* at 477 n.6; *see also Weaver v. Marine Bank*, 637 F.2d 157, 161 (3d Cir. 1980), *rev'd*, 102 S. Ct. 1220 (1982).

an investment contract.<sup>373</sup> Indeed, it has been indicated that a profit-sharing agreement is merely a synonym for investment contract.<sup>374</sup> For instance, in the case *Teamsters v. Daniel*,<sup>375</sup> the United States Supreme Court stated that:

Respondent also argues that his interest constitutes a "certificate of interest or participation in any profit-sharing agreement." The court below did not consider this claim, as respondent had not seriously pressed the argument and the disposition of the "investment contract" issue made it unnecessary to decide the question. Similarly, respondent here does not seriously contend that a "certificate of interest . . . in any profit-sharing agreement" has any broader meaning under the Securities Acts than an "investment contract." In *Foreman, supra*, we observed that the *Howey* test, which has been used to determine the presence of an investment contract, "embodies the essential attributes that run through all of the Court's decisions defining a security."

Although this quote is not definitive, it strongly suggests that a profit-sharing agreement exists only if the particular scheme would qualify as an investment contract. The court in *Hirk v. Agri-Research Counsel, Inc.* also stated that there is no real difference between an investment contract and a profit-sharing arrangement.<sup>376</sup> Thus, the considerations discussed in the investment contract section above will be equally applicable in determining whether a SAM is a profit-sharing agreement. Further, an examination of the commentary related to profit-sharing agreements illustrates that a SAM is not similar to the usual types of arrangements classified as profit-sharing agreements.

Professor Loss is one of the few commentators to discuss the phrase "profit-sharing agreement." He stated:

The classic example of a "certificate of interest or participation in [a] profit-sharing agreement" is a contract whereby the buyer furnishes the funds and the seller the skill for speculating in the stock or commodity markets under an arrangement to split any profits.<sup>377</sup>

The arrangement that Professor Loss described bears little resemblance to a SAM. In both Professor Loss' example and a SAM, funds are

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373. *Teamsters v. Daniel*, 439 U.S. 551 (1979); *Hirk v. Agri-Research Counsel, Inc.*, 561 F.2d 96, 102 (7th Cir. 1977). One opinion has stated that the various categories "are not mutually exclusive and are meant to be 'catchalls.'" *Tcherepnin v. Knight*, 371 F.2d 374, 381 (7th Cir.), *rev'd on other grounds*, 389 U.S. 332 (1967).

374. Securities Act of 1933 Release No. 5211 (Nov. 30, 1971) (referring to profit-sharing agreements "or" investment contracts in a context implying that the two terms are synonymous).

375. 439 U.S. 551, 558 n.11 (1979) (citation omitted).

376. 561 F.2d 96, 102 (7th Cir. 1977). "[C]ourts have made no real distinction between investments contracts and profit-sharing plans."

377. 1 L. Loss, *supra* note 371, at 489.

invested with the expectation of profit. In both cases, the profits made by the seller (borrower) will be shared with the buyer (lender). There are, however, significant differences between a SAM and the example described by Professor Loss. First, in a SAM, the lender is assured of return of principal plus a minimum return on its investment by virtue of the fixed interest obligation; an investor in stocks is not guaranteed to receive even a repayment of principal. Second, the SAM borrower is not using the funds for an investment in a speculative venture. Further, the investment in a SAM is not based on the "skill" of the borrower. Thus, it would appear that a SAM would not be considered to be a profit-sharing agreement.

The recent cases involving profit-sharing agreements are also distinguishable from SAMs.<sup>378</sup> Thus, SAMs will only be construed as profit-sharing agreements if they are also investment contracts.

### Partnership vs. Debt

A partnership is presumed when parties enter into an agreement to share profits.<sup>379</sup> Unlike an equity participation arrangement, it is important that the parties to a SAM not be construed as partners. If the parties to a SAM were found to be partners rather than lender and borrower, several important features of the SAM would be altered,

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378. For instance, in *United States v. Davis*, 40 F. Supp. 246 (N.D. Ill. 1941), the court found that a certificate reciting that a person had become a member of a cooperative association and was entitled to participate in the distribution of certain profits was a profit-sharing agreement. In *SEC v. Addison*, 194 F. Supp. 709 (N.D. Tex. 1961), the defendants solicited unsecured loans, the proceeds of which were to be used to develop uranium mining claims through the use of a "Benson Upgrader," a machine which, by adding "certain component parts" to low-grade unmarketable ore, transformed the ore into marketable quality. *Id.* at 715. The court had little trouble in finding that a collateral agreement by which the lenders were also guaranteed a percentage of the profits from the proposed mining venture was a profit-sharing agreement within the meaning of the 1933 Act.

*SEC v. Glenn W. Turner Enters.*, 348 F. Supp. 766 (D. Ore. 1972), involved a pyramid scheme in which product distributors earned most of their income not from product sales but from recruiting other distributors; a distributor joining the program paid a fee to the promoter which in turn shared a portion of that income with the member who had recruited the new distributor. The district court found that "[t]he significant efforts in this promotion are the specialized, professional, highpowered tactics used at these meetings by [the promoter], and the ordinary investors by themselves would be unsuccessful at persuading anyone else of parting with \$2,000 to \$5,000." *Id.* at 775. The district court concluded that the scheme was both an investment contract and a profit-sharing agreement. On appeal, the decision was affirmed solely on the basis of the investment contract analysis. 474 F.2d 476, 480 (1973).

In both *Addison* and *Glenn W. Turner* there were express findings that the success of the venture depended solely or primarily upon the efforts of the promoter and not the investor.

379. *Dills v. Delira Corp.*, 145 Cal. App. 2d 124, 302 P.2d 397 (1956); CAL. CORP. CODE § 15007 (West 1977).

making this financing arrangement less attractive. First, a junior lienor might be able to claim priority over the SAM lien by asserting that the SAM did not establish a valid mortgage because the relationship between the parties was not one of mortgagor/mortgagee.<sup>380</sup> Second, if the lender were deemed to be the borrower's partner, rather than a mortgagee, the borrower might be able to prohibit the lender from asserting its right of foreclosure.<sup>381</sup> Third, certain important tax features of a SAM,<sup>382</sup> such as the interest deduction, might not be available if the payment of contingent deferred interest were a sharing of profits rather than a payment of interest. Fourth, the lender might become jointly liable for the debts and liabilities relating to the property.

The California Corporations Code defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit."<sup>383</sup> Section 15007 of the California Corporations Code provides that receipt of a share of the profits is *prima facie* evidence that the recipient is a partner unless "such profits were received in payment: (a) [a]s a debt by installments or otherwise . . . [or] (d) [a]s interest on a loan, though the amount of payment vary with the profits of the business."<sup>384</sup>

This provision prevents any inference that SAMs create partnerships. Although all SAM lenders receive profits from the property to the extent that they receive a portion of the appreciation, the existence of a partnership cannot be inferred because the profit relates to an installment debt or loan. The Corporations Code also provides that two parties must be co-owners in order to be partners.<sup>385</sup> The parties to a SAM are not co-owners; the lender does not hold fee title to, or control over the management of, the property, but is merely a mortgagee.<sup>386</sup> Finally, the Corporations Code requirement<sup>387</sup> that partners carry on a business is not satisfied, because there is no co-owned business.

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380. See CAL. CORP. CODE § 15040 (West 1977) ("creditors other than partners" rank first in order of payment of partnership liabilities upon dissolution).

381. A creditor of a partnership, if also a partner, may experience several undesirable results, the most serious of which is the inability to sue on its note. An Illinois Supreme Court decision illustrates this dilemma: "While the note remained in the hands of Davison [a partner], as assignee, he could not have enforced its payment by suit at law, for the reason that he could not have sued himself as maker. A party cannot be both plaintiff and defendant in an action at law, and the other nine makers of the note were not liable without Davison." *Kipp v. McChesney*, 66 Ill. 460, 463 (1872).

382. See *supra* notes 274-318 & accompanying text.

383. CAL. CORP. CODE § 15006 (West 1977).

384. *Id.* § 15007(4) (West 1977).

385. *Id.* § 15006(1) (West 1977).

386. See *supra* notes 17-20 & accompanying text.

387. CAL. CORP. CODE § 15006(1) (West 1977).

Case law also supports the conclusion that the parties to a SAM are not partners. One element necessary to create a partnership is an understanding between the two parties that both profits and losses of a business will be shared.<sup>388</sup> In a SAM, the lender has only a profit interest in the property in the form of a share of the appreciation of the property's value. If the secured property depreciates, the lender is not obligated to compensate the borrower for any losses resulting from the decline in value, and the payment obligation with respect to the principal and fixed interest is not affected.

Another necessary element of a partnership is the right of all partners to participate in the management and control of the business. In *Bank of California v. Connolly*,<sup>389</sup> a California appellate court stated that receipt of profits alone from a venture does not make a participant a partner. An "essential element" of a partnership is the right of joint participation in the management and control of the business.<sup>390</sup> "An agreement by a landowner to share with another profits to be derived from the sale of land does not, without more, create a partnership or joint venture relationship."<sup>391</sup>

The *Connolly* line of cases establishes that managerial activity is a principal element of a partnership. In most SAMs, lenders will have little, if any, participation in the management and control of the business. Parties to a SAM should limit the lender's participation in order

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388. *E.g.*, *Nelson v. Abraham*, 29 Cal. 2d 745, 177 P.2d 931 (1947); *Vogel v. Bankers Bldg. Corp.*, 112 Cal. App. 2d 160, 245 P.2d 1069 (1952).

389. 36 Cal. App. 3d 350, 111 Cal. Rptr. 468 (1973).

390. *Id.* at 364, 111 Cal. Rptr. at 478; *see also In re Mission Farms Dairy*, 56 F.2d 346 (9th Cir. 1932); *Fritz v. Gilbert*, 8 Cal. 2d 68, 70-71, 63 P.2d 291, 292-93 (1936); *Coward v. Clanton*, 122 Cal. 451, 454, 55 P. 147, 148 (1898); *Pearson v. Norton*, 230 Cal. App. 2d 1, 40 Cal. Rptr. 634 (1964); *Dills v. Delira Corp.*, 145 Cal. App. 2d 124, 302 P.2d 397 (1956); *Mulligan v. Wilson*, 94 Cal. App. 2d 286, 291-92, 210 P.2d 526, 529 (1949); *Black v. Brundige*, 125 Cal. App. 641, 13 P.2d 999 (1932); *Freeman v. Sullivan*, 86 Cal. App. 200, 260 P. 807 (1927); *People v. Hotz*, 85 Cal. App. 450, 259 P. 506 (1927).

391. 36 Cal. App. 3d at 364, 111 Cal. Rptr. at 478; *see also Dills v. Delira Corp.*, 145 Cal. App. 2d 124, 302 P.2d 397 (1956), in which plaintiffs loaned defendant money for the production of a radio show. As partial repayment, defendant agreed to pay plaintiff 26-2/3% of the profits from the first run of the show. Plaintiff claimed that a partnership was thereby established and that he should receive 26-2/3% of all productions of the show. The court held that no partnership was created because, although a partnership relation is to be presumed in a profit-sharing agreement, "such presumption evaporates when substantial evidence is introduced, as here, showing the relationship to be one of borrower-lender with the profit share's [sic] being paid for service rendered or money advanced." 145 Cal. App. 2d at 131, 302 P.2d at 402 (1956).

A limited partner's right to participate in the management and control of the partnership is limited to certain specified items. CAL. CORP. CODE § 15507 (West 1977 & Supp. 1982). However, a limited partnership cannot be formed on a de facto basis, but only by the execution and recordation of an appropriate certificate. *Id.* § 15502 (West 1977).



to avoid any inference that the parties are partners. Nevertheless, operating covenants in the loan documents, similar activities, and participation by the lender in profits, should not result in a characterization as a partnership where such activities are undertaken by the lender to protect its security.

Whereas the California SAM statute avoids the partnership problem by specifying that the parties' relationship is that of debtor and creditor,<sup>392</sup> nonstatutory SAM borrowers and lenders can draft their agreements to help ensure that the inference of a partnership is not made. The documents evidencing the loan should state that the relationship between the parties is one of lender and borrower with no partnership relationship intended. The document should further explain the purpose and justification for the particular profit-sharing arrangement. Such statements will successfully avoid any conclusion that a partnership exists.

### Clogging the Equity of Redemption

Beginning with fourteenth century English common law, borrowers wishing to convey security to lenders did so by granting fee simple title to the real property by means of a deed on condition subsequent. The deed provided that, if the debt were paid on the day of maturity of the obligation, the title to the realty would revert to the borrower.<sup>393</sup> If the due date of the debt passed without repayment, then the condition subsequent failed, and the lender's title became absolute.<sup>394</sup>

This "clumsy"<sup>395</sup> security device has survived to the present time in spite of basic imperfections making it an ill-fitting tool for its purpose and in spite of complaints dating back more than six centuries.<sup>396</sup>

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392. CAL. CIV. CODE § 1917.160 (West Supp. 1982). "The relationship of the borrower and the lender, as to a shared appreciation loan, is that of debtor and creditor and shall not be . . . a . . . partnership . . . ."

393. G. OSBORNE, *supra* note 158, at 8. A conditional grant (e.g., one which stated, "If I [the borrower] fail to pay my debt when due, fee title to the real estate will vest in you at that time.") was prohibited by the common law injunction against springing interests. F. WALSH, A TREATISE ON MORTGAGES 3-4 (1934).

394. S. LITTLETON, TENURES (c. 1481), as reprinted in translation in LITTLETON'S TENURES IN ENGLISH § 332 (V. & R. Stevens & G.S. Norton ed. 1845). Littleton explains the word "mortgage," which in French means "dead pledge," to have originated because the pledge becomes dead (i.e., the debtor loses his land forever) if the debt is not paid on the due date. *Id.*

395. G. OSBORNE, *supra* note 158, at 8.

396. Compare 3 D. HOLDSWORTH, HISTORY OF ENGLISH LAW 130 n.5 (3d ed. 1923) (quoting Anon. v. Anon., Eyre of Kent, Y.B. 6, 7 Ed. II (1314), as reprinted in 29 Seld. Soc. Pub. 85 (1913)), with G. OSBORNE, *supra* note 158, at 8-9. See also *id.* at 12; 2 F. POLLOCK & F. MAITLAND, HISTORY OF ENGLISH LAW 124 (2d ed. 1909).

The imperfections in large part originally arose out of the fact that the form of mortgage which was used was on its face a deed which nowhere referenced the fact that the sole purpose of the transfer was as security. As Maitland said several centuries later, "That is the worst of our mortgage deed . . . it is one long *suppressio veri* and *suggestio falsi*. It does not in the least explain the rights of the parties; it suggests that they are other than really they are."<sup>397</sup> Early on, this imperfection was compounded by various other problems, e.g., failure properly and expressly to provide for the reversionary right.<sup>398</sup> Additionally, failure to pay the debt precisely on the due date resulted in forfeiture of the land; the law courts enforced the deeds strictly without flexibility.<sup>399</sup>

English courts of equity, however, were unwilling to countenance the easy forfeiture of the debtor's title and, contrary to the express wording of the parties' agreement, began to give the borrower an equitable right to redeem the property upon payment of the debt.<sup>400</sup> Originally the equity courts intervened only in cases where the mortgagor had in fact performed, or where fraud or oppression existed, or where other circumstances prevented timely repayment.<sup>401</sup> As one commentator explained, the intervention of equity was necessary "to prevent the property being withheld in breach of good faith by the creditor. And it was a breach of good faith because the purpose of the transaction was security."<sup>402</sup> During the sixteenth century, the Chancellor's intervention was limited primarily to instances where the debt had in fact been satisfied.<sup>403</sup> In the decades before 1625, relief was granted in cases where fraud, hardship, oppression, mistake or other typical grounds for equitable jurisdiction existed, even though the date for payment had passed and the mortgagee's title was absolute at law.<sup>404</sup>

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397. F. MAITLAND, *EQUITY* 269 (1929) (footnote omitted).

398. R. TURNER, *THE EQUITY OF REDEMPTION* 22 (1931) (citing *inter alia* Y.B. Trin. 9 Edw. 4, f. 25, pl. 34 (1469)). Turner's reference to plea 34 is an error; the intended reference is to plea 33.

399. F. WALSH, *LAW OF MORTGAGES* 6 (1934).

400. See 5 D. HOLDSWORTH, *supra* note 396, at 293; G. OSBORNE, *supra* note 158, at 12-13; R. TURNER, *supra* note 398, at 21-22.

401. *E.g.*, *Bodenham v. Halle* (Ch. 1456), as reprinted in 10 Seld. Soc. Pub. 137 (1896). In that case, the supplication to the Chancellor complained that the loan was usurious, the borrower's manor had been deeded to the lender, and the borrower imprisoned for the debt pursuant to a statute-merchant issued by him, all in spite of the fact that he was apparently willing and able to pay the debt. (He did so at the hearing in the Chancery.) According to the supplication, such a situation was against "ryght [right] and conscience, in fynall [final] distrucccion [destruction] of the saide [supplicant] Robert." *Id.* at 138.

402. G. OSBORNE, *supra* note 158, at 12.

403. R. TURNER, *supra* note 398, at 22, 24.

404. *Id.* at 25-27; F. WALSH, *supra* note 393, at 7, 9.

The report of a case in 1625 shows that, as of that date, the need for a showing of special circumstances was eliminated, and the courts began allowing redemption as a matter of right after the due date for payment had passed. Mentioning no special circumstances, the report says that, though the mortgage was "void" (i.e., redeemed) in law if paid at the due date, the mortgage "ought to be void in Equity" though paid after that date.<sup>405</sup>

Thereafter, a general rule arose allowing redemption in all cases, provided only that the debt be paid within a reasonable time, and further that the lender could seek a decree foreclosing the right of redemption if payment were not made.<sup>406</sup> This equity of redemption was a "right not given by the terms of an agreement between the parties to it, but contrary to them . . ."<sup>407</sup> Thus, courts of equity freely altered the parties' express agreement in order to prevent forfeiture. This was done for the simple reason that the documentation did not reflect the true relationship between the parties.<sup>408</sup>

Soon, however, attempts were begun by lenders to hinder or prevent the borrower from redeeming. One opinion refers to cases "where the mortgagee [would] suddenly bestow unnecessary costs upon the mortgaged lands, of purposes to clogg [sic] the lands, to prevent the mortgagor's redemption."<sup>409</sup> The equity courts responded that attempts to prevent the mortgagor from redeeming would not be tolerated,<sup>410</sup> and the doctrine voiding any clogs on the equity of redemption grew. Although many may suppose that the ancient rule prohibiting a lender from imposing any clog on the debtor's equity of redemption

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405. *Emanuel College v. Evans*, 1 Chan. Rep. 18, 20, 21 Eng. Rep. 494, 495 (1625-26). The mortgage instrument took the form of a 500-year lease (with a reserved life estate after the term), thus having the dubious significance of being one of the earliest unsuccessful efforts to end-run restrictions on mortgages by using a hidden security device or equitable mortgage. One third of a millenium later, some obligees unsuccessfully attempt the same artifice. *E.g.*, *Humble Oil & Refining Co. v. Doerr*, 123 N.J. Super. 530, 303 A.2d 898 (1973).

406. *E.g.*, *Bromley v. Dorell*, Tothill 134, 21 Eng. Rep. 146 (undated); *How v. Viguers*, 1 Chan. Rep. 32, 21 Eng. Rep. 499 (1628-29); R. TURNER, *supra* note 398, at 27.

407. *Salt v. Marquess of Northampton*, 1892 A.C. 3, 18 (1891).

408. The identical situation continues to occur today. *E.g.*, *Coast Bank v. Minderhout*, 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

409. *Bacon v. Bacon*, Tothill 133, 133-34, 21 Eng. Rep. 146 (1639-40).

410. See also, for example, cases cited *infra* in notes 418-22. In one case, the report of the opinion states that, if the instrument in question was truly serving the purpose of a mortgage, then no words could bar the equity of redemption because, if that were to be tolerated, "the scriveners would cozen all mortgagors out of their estates." *Newcombe v. Bonham*, 2 Freeman 67, 68, 22 Eng. Rep. 1063 (1681), *rev'd on other grounds*, 1 Vern. 232, 23 Eng. Rep. 435 (1684).

died a deserved death a couple of centuries ago,<sup>411</sup> the relatively recent invocation of it by a New Jersey court<sup>412</sup> precludes dismissing its potential applicability to SAMs.

*Once a Mortgage, Always a Mortgage*

The rule falls into three parts, as set forth by Lord Davey:

The first doctrine to which I refer is expressed in the maxim, "Once a mortgage always a mortgage." The second is that the mortgagee shall not reserve to himself any collateral advantage outside the mortgage contract; and the third is that a provision or stipulation which will have the effect of clogging or fettering the equity of redemption is void.<sup>413</sup>

In an early case, a borrower deeded the property with a covenant that, should he fail to repay the debt, he would be barred "from all equity of redemption."<sup>414</sup> The Lord Chancellor held that the borrower's heir could redeem, "for being once redeemable and once a mortgage, the negative words shall not make it otherwise."<sup>415</sup> Further, it is a "general rule, *once a mortgage, and always a mortgage* . . . ."<sup>416</sup> This maxim is another way of saying that a mortgage cannot be made irredeemable, and a provision to that effect is void.<sup>417</sup>

Situations violating this maxim include: limiting or prohibiting redemption;<sup>418</sup> allowing the mortgagee to keep some part of the mortgaged property, limiting redemption to the balance;<sup>419</sup> increasing the interest rate upon default;<sup>420</sup> granting an option or right of first refusal to the lender to purchase the mortgaged property;<sup>421</sup> and providing for

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411. As will be seen from the following discussion, all substantive content of this doctrine has been superseded by modern statutory and case law relating to, e.g., usury, unconscionability, rights of redemption, foreclosure procedures, etc.

412. *Humble Oil & Refining Co. v. Doerr*, 123 N.J. Super. 530, 303 A.2d 898 (1973). This case involved a relatively sophisticated party taking an option on property as a part of the same transaction in which it obtained an equitable mortgage on the property. The option was found to be a clog on the equity of redemption of the debtor, and therefore void.

413. *Noakes & Co. v. Rice*, 1902 A.C. 24, 32 (1901).

414. *Newcombe v. Bonham*, 2 Freeman 67, 22 Eng. Rep. 1063 (1681), *rev'd on other grounds*, 1 Vern. 232, 23 Eng. Rep. 435 (1684).

415. *Id.* at 68, 22 Eng. Rep. at 1063.

416. *Newcomb v. Bonham*, 1 Vern. 7, 8, 23 Eng. Rep. 266, 267 (1681), *rev'd on other grounds*, 1 Vern. 214, 23 Eng. Rep. 422 (1684).

417. *Noakes & Co. v. Rice*, 1902 A.C. 24, 32 (1901).

418. *See East India Co. v. Atkyns*, 1 Comyns 346, 92 Eng. Rep. 1105 (1720).

419. *Salt v. Marquess of Northampton*, 1892 A.C. 1 (1891).

420. *Strode v. Parker*, 2 Vern. 316, 23 Eng. Rep. 804 (1694); *Holles v. Wyse*, 2 Vern. 289, 23 Eng. Rep. 787 (1693).

421. *Willett v. Winnell*, 1 Vern. 488, 23 Eng. Rep. 611 (1687); *Orby v. Trigg*, 9 Mod. 2, 88 Eng. Rep. 276 (1722); *Re Edward's Estate*, 11 Ir. Ch. 367 (1861); *Humble Oil & Refining Co. v. Doerr*, 123 N.J. Super. 530, 303 A.2d 898 (1973).

the preemption of the equity of redemption by the mortgagee.<sup>422</sup> Thus, any provision of a mortgage that operated to prevent or hinder redemption was void because it conflicted with an essential element of a mortgage, its ability to be redeemed.

Several aspects of SAMs are sufficiently analogous to the situations cited above<sup>423</sup> to raise a question whether SAMs violate the rule. Arguably, allowing a lender to keep a portion of the profits on resale is the economic equivalent of allowing the lender to keep a portion of the property after redemption, and such a provision is therefore void.<sup>424</sup> Of course, the lender in a SAM is not keeping any part of the property, and the owner has the full and unfettered right to control and sell the entirety of the property. The SAM merely provides that a portion of the interest payable by the borrower will be determined by the property's appreciation.

The rule disallowing a borrower from forfeiting a portion of the property in advance merely rephrases the rule forbidding the borrower from divesting in advance its redemption rights.<sup>425</sup> Nothing in the anti-clogging rule, however, indicates that a borrower and lender cannot share some of the economic risks and benefits of property ownership, thereby allowing the borrower the benefits of a lower interest rate if the property does not greatly appreciate. Conversely, nothing in a SAM confers on the lender any power of strict foreclosure; if there is a default, the lender must foreclose by the appropriate procedures before obtaining any interest.

Alternatively, it can be argued that contingent interest payments are similar to the increase in interest rate upon default condemned in some cases.<sup>426</sup> The distinction, however, is that the increase in interest rate occurs after default as a result of default, whereas the contingent interest accrues before maturity and is payable at maturity.

The "once a mortgage" rule grew out of a need to prevent a mortgage from containing any condition which was "repugnant"<sup>427</sup> to the debtor's right to redeem. In view of the redemption protections contained in modern statutory law,<sup>428</sup> the "once a mortgage" rule has become superfluous.

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422. *Jennings v. Ward*, 2 Vern. 520, 23 Eng. Rep. 935 (1705).

423. *See supra* notes 418-22 & accompanying text.

424. *See supra* note 419 & accompanying text.

425. *See supra* note 419.

426. *See supra* note 420 & accompanying text.

427. *Kreglinger v. New Patagonia Meat & Cold Storage Co.*, 1914 A.C. 25, 56 (1913).

428. *E.g.*, CAL. CIV. PROC. CODE § 726 (West 1980); CAL. CIV. CODE § 2924 (West 1974 & Supp. 1982).

*Collateral Advantage and Fettering the Equity of Redemption*

The second part of Lord Davey's maxim, the rule against collateral advantage,<sup>429</sup> had grown at one time in the English courts into a "crystallized" and absolute rule forbidding any collateral advantage to a lender whatsoever.<sup>430</sup> In the relatively early leading case of *Jennings v. Ward*,<sup>431</sup> the mortgagee, at the time of making the loan, not only took a mortgage securing principal and interest, but also extracted from the borrower an agreement granting the lender on demand rents and profits out of the property. The court held, "A man shall not have interest for his money, and a collateral advantage besides for the loan of it, or clog the redemption with any by-agreement."<sup>432</sup> This language does not appear to be the rationale for the decision, but the conclusion following from it. It is of substantial significance that, strictly speaking, the case's rationale was not that all collateral advantage was voidable but that the collateral agreement must be "set aside . . . as unconscionable."<sup>433</sup>

For more than two centuries following *Jennings*, courts appeared to struggle with the "collateral advantage" rule, wavering between a flexible rule voiding only unconscionable bargains, and a more rigid, absolutist rule voiding any provision constituting a collateral advantage.<sup>434</sup> In 1898, much of the rigidity of the *Jennings* rule was overturned by *Biggs v. Hoddinott*.<sup>435</sup> The *Biggs* court, in fact, noted that:

The proposition stated in *Jennings v. Ward* is too wide. If properly guarded it is good law and good sense. A mortgage is regarded as a security for money, and the mortgagor can always redeem on payment of principal, interest, and costs; and no bargain preventing such redemption is valid, nor will unconscionable bargains be enforced. There is no case where collateral advantages have been disallowed which does not come under one of these two heads.<sup>436</sup>

The court upheld the right of the lender, a brewer, to require the borrower, a hotel owner, to purchase beer from the lender during the term of the mortgage. The court noted several times that the collateral

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429. Though never clearly defined in the cases, "collateral advantage" means any benefit, other than payment of interest, which a lender receives in return for the making of a loan. See *infra* text accompanying notes 430-47.

430. Williams, *Clogging the Equity of Redemption*, 40 W. VA. L.Q. 31, 47-49 (1933).

431. 2 Vern. 520, 23 Eng. Rep. 935 (1705).

432. *Id.* at 521, 23 Eng. Rep. at 935.

433. *Id.*

434. See G. OSBORNE, *supra* note 158, at 149-50; R. TURNER, *supra* note 398, at 175-83.

435. [1898] 2 Ch. 307.

436. *Id.* at 321 (footnote omitted).

agreement in no way hindered the borrowers from redeeming.<sup>437</sup>

A schizophrenia developed in the case law on the collateral advantage rule. On the one hand, Lord Davey made clear that the original rule against collateral advantage was based solely on the courts' desire to void transactions that "tended" to usury<sup>438</sup> or were unconscionable. With the repeal of many usury laws, he argued, the rule should be limited to collateral advantages of an unconscionable nature.<sup>439</sup> On the other hand, Lord Davey<sup>440</sup> confirmed that the collateral advantage rule had an independent off-spring; the rule against "fetters" on the equity of redemption<sup>441</sup> absolutely prohibited any collateral advantage extending beyond the term of the mortgage.

The leading case of *Kreglinger v. New Patagonia Meat & Cold Storage Co.*<sup>442</sup> overturned the absolutist aspects of the collateral advantage rule even in cases where the advantage extended beyond the term of the loan.<sup>443</sup> According to *Kreglinger*, a mortgage provision violates the

437. *Id.* at 321, 323.

438. *Noakes & Co. v. Rice*, 1902 A.C. 24, 33 (1901). In a large number of cases involving this rule, what displeased the equity courts was not the fact of collateral advantage per se, but that the lender's return from the benefits of the collateral agreement, plus the return from the income actually denominated interest, constituted a total return (i.e., total interest) in excess of the usury limits then in effect. *Id.* Modern courts do not resort to the difficult doctrine of collateral advantage, but rather convert the collateral benefit to monetary terms, ascertain the resulting interest rate, add that rate to the fixed rate, and determine whether the sum total exceeds the applicable usury rate. See, e.g., *Sandell, Inc. v. Bailey*, 212 Cal. App. 2d 920, 28 Cal. Rptr. 413, cert. denied, 374 U.S. 831 (1963); *Schiff v. Pruitt*, 144 Cal. App. 2d 493, 301 P.2d 446 (1956); *Goodwin v. Alston*, 130 Cal. App. 2d 664, 280 P.2d 34 (1955); *Traders Credit Corp. v. Thyle*, 116 Cal. App. 252, 2 P.2d 568 (1931); *Calimpco, Inc. v. Warden*, 100 Cal. App. 2d 429, 224 P.2d 421 (1950)3.

439. *Noakes & Co. v. Rice*, 1902 A.C. 24 (1901): "My Lords, the second doctrine to which I refer, namely, that the mortgagee shall not reserve to himself any collateral advantage outside the mortgage contract, was established long ago when the usury laws were in force. The Court of Equity went beyond the usury laws, and set its face against every transaction which tended to usury. It therefore declared void every stipulation by a mortgagee for a collateral advantage which made his total remuneration for the loan indirectly exceed the legal interest. I think it will be found that every case under this head of equity was decided either on this ground, or on the ground that the bargain was oppressive and unconscionable. The abolition of the usury laws has made an alteration in the view the Court should take on this subject, and I agree that a collateral advantage may now be stipulated for by a mortgagee, provided that no unfair advantage be taken by the mortgagee which would render it void or voidable, according to the general principles of equity, and provided that it does not offend against the third doctrine [i.e., the doctrine forbidding the fettering of the equity of redemption]. On these grounds I think the case of *Biggs v. Hoddinott* in the Court of Appeal was rightly decided." *Id.* at 32 (footnote omitted); see also *Kreglinger v. New Patagonia Meat & Cold Storage Co.*, 1914 A.C. 25 (1913).

440. *Noakes v. Rice*, 1902 A.C. 24 (1901).

441. See *infra* text accompanying note 445.

442. 1914 A.C. 25 (1913).

443. A quotation by Lord Davey in *Noakes & Co. v. Rice*, 1902 A.C. 24, 33-34 (1901), in

rule against clogs on the equity of redemption only if it is "unconscionable," or if it is a "penal clause" or if it was in the nature of a "condition repugnant," i.e., a condition preventing or unduly hindering redemption so as to violate the "once a mortgage" rule.<sup>444</sup>

### *Conclusion*

The common law prohibition against fettering the equity of redemption or otherwise clogging the equity of redemption beyond the date of redemption is not applicable to SAMs. The collateral advantage of a SAM, if one exists,<sup>445</sup> expires upon redemption, preventing any violation of the rule against fettering.

The common law rule prohibiting all other collateral advantages grew out of concerns of usury and unconscionability.<sup>446</sup> These concerns have been eliminated by modern statute and case law on the subjects. The usury issues raised by SAMs have been discussed;<sup>447</sup> the following section examines the modern rules regarding unconscionability.

### **Unconscionability**

In 1979 the California legislature enacted a statute allowing courts to void a contract or provision thereof on the basis of unconscionability.<sup>448</sup> However, neither the courts<sup>449</sup> nor the legislature has been able

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which he states that the fettering rule is a variation on the rule of "once a mortgage, always a mortgage," suggests that the later cases speaking of "fettering" are all actually cases which should be treated under either the collateral advantage rule or the "once a mortgage" rule. The only common thread to the fettering cases is that some right or benefit extends beyond the date of redemption. An example of the type of case to be treated under the collateral advantage rule is *Kreglinger v. New Patagonia Meat & Cold Storage Co.*, 1914 A.C. 25 (1913), in which the lender had a right under a contract to buy sheep skins from the borrower for five years. The court upheld the contract, notwithstanding earlier redemption of the mortgage, because it was not unconscionable. Furthermore, it should be noted that, as with cases running afoul of the "once a mortgage" rule, this type of contract does not work to prevent full and actual redemption of the mortgaged property. A case of the type falling within the "once a mortgage" rule is one in which the mortgagor retained the right to profits from operation of the mortgaged property for a period after the property's redemption. *Santley v. Wilde*, [1899] 2 Ch. 474 (1899). That case approved the agreement, but was overruled by *Bradley v. Carritt*, 1903 A.C. 253; see also G. OSBORNE, *supra* note 158, at 149-50.

444. 1914 A.C. 25, 56 (1913). As one commentator put it, "Equity finally returned like the prodigal to an original jurisdiction of rebuking forfeitures and relieving hardship, abandoning the vagaries of 'clogging.'" Williams, *supra* note 430, at 49.

445. See *infra* text accompanying notes 446-47.

446. See *supra* text accompanying notes 442-44.

447. See *supra* notes 77-127 & accompanying text.

448. CAL. CIV. CODE § 1670.5 (West Supp. 1982) provides:

"(a) If the court as a matter of law finds the contract or any clause of the contract to



to define unconscionability. The legislative history, however, is of some help. It first states, in tautological fashion, that the basic test of unconscionability "is whether, in the light of the general background and the needs of the particular case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract."<sup>450</sup> The comment continues by stating that "[t]he principle is one of the prevention of oppression and unfair surprise and not of disturbance of allocation of risks because of superior bargaining power."<sup>451</sup>

Thus the test for this factual determination remains quite skeletal. Certainly adequate and meaningful disclosures to the borrower appear essential in order to prevent "unfair surprise." In the case of a SAM, disclosures to the borrower of how the contingent deferred interest accrues should occur before the loan is made, and, during the term of the loan, the borrower should be kept informed of the amount of interest he or she will be required to pay upon maturity.<sup>452</sup>

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have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

"(b) When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose, and effect to aid the court in making the determination."

449. In *Swanson v. Hempstead*, 64 Cal. App. 2d 681, 149 P.2d 404 (1944), the court stated: "An 'unconscionable contract,' the authorities are agreed, is one 'such as no man in his senses and not under a delusion would make on the one hand, and as no honest and fair man would accept on the other.' Whether or not a contingent fee contract is unconscionable, even were that term to be given a less drastic meaning than the authorities ascribe to it, must be determined upon the situation as it fairly appears to the parties at the time it is entered into, not as subsequent events reveal it to be. Implicit in the nature of the contract is speculation on the outcome." *Id.* at 688, 149 P.2d at 407-08 (citations omitted). The case is significant, not only for its definition, but for its emphasis on the fact that unconscionability must be adjudged on the basis of the facts at the time the contract is entered, not by hindsight. In *Graham v. Scissor-Tail, Inc.*, 28 Cal. 3d 807, 623 P.2d 165, 171 Cal. Rptr. 604 (1981), the court found a contract to be unconscionable. Though the opinion is 21 pages long, the conclusion is reached without any indication whatsoever of the reasoning or legal test used by the court in reaching the decision. Nor is there any citation of authority, other than a quote from a case involving a collective-bargaining contract, in which the United States Supreme Court held that "minimum levels of integrity" would not be met where "the employee's representation by the union has been dishonest, in bad faith, or discriminatory." *Id.* at 825, 623 P.2d at 176, 171 Cal. Rptr. at 615 (quoting *Hines v. Anchor Motor Freight*, 424 U.S. 554, 571 (1976)). This test seems even harsher than that in *Swanson v. Hempstead*.

450. CAL. CIV. CODE § 1670.5, Legislative Committee Comment-Assembly (West 1979).

451. *Id.* (citation omitted).

452. It is not suggested that an appraisal be made periodically, only that a set or range of hypothetical calculations be provided, letting the borrower determine how much the property actually has appreciated.

As to "oppression," an allocation of profits between borrower and lender in the ratio prescribed by the California SAM statute would, by virtual statutory definition, not be oppressive. The same would seem to be true even if a substantially larger proportion were allocated to the lender. However, the other extreme of allocating all profits in return for a SAM equal to ten or twenty percent of the purchase price might be unconscionable if the borrower has a substantial equity investment in the property.<sup>453</sup>

### Practical Problems

A SAM raises a variety of practical questions not presented by traditional loans. Like the legal questions, these questions should be addressed before a SAM is consummated.

#### Improvements

One question involves valuation of a borrower's capital investment in improvements to the secured property, made during the term of the SAM, when determining apportionment of the appreciated value of the secured property.<sup>454</sup> A SAM lender would discourage capital improvement of the secured property unless a borrower was assured that the cost or added value of any improvements would be considered in assessing the amount of contingent deferred interest payable to the lender.

Examining this issue, two subsidiary problems arise. First, a distinction must be made between expenditures for capital improvements and those for repair, replacement, maintenance and normal upkeep. Second, because a borrower's investment in certain improvements, such as garages or new kitchens, may appreciate the value of a home above the cost of the improvement, and because other improvements, such as swimming pools, may appreciate the value of a home less than the cost of the improvement,<sup>455</sup> a formula based on value, rather than cost, though more difficult to administer, may be desirable.

Of the numerous comments made on this problem,<sup>456</sup> the Califor-

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453. In the illustration just given, if the SAM is a second mortgage substantially or totally replacing the borrower's down payment, allocating most or all of the profits to the SAM lender should not be oppressive.

454. See CAL. CIV. CODE § 1917.150-.151 (West Supp. 1982).

455. McKenzie, *A Comprehensive Look at Shared-Appreciation Mortgages*, FHLBB J., Nov. 1980, at 11, 14; Letter from California Association of Realtors to the Secretary, FHLBB at 3 (Nov. 25, 1980).

456. See, e.g., *Senate Committee on Banking and Commerce, Analysis of AB 2168 (Costa)*

nia SAM statute is again the most comprehensive. The statute requires borrowers to submit to lenders proof of cost and an estimate of the increase in the property's value by reason of any improvement costing more than \$2,500 during any twelve-month period.<sup>457</sup> The lender has thirty days to contest the claimed increase in value of the property.<sup>458</sup> If the claimed increase is contested, the borrower and lender may either establish the value of appreciation by mutual agreement or by appraisal.<sup>459</sup>

Two issues are not resolved by the statute. First, if a borrower consistently makes minor improvements that appreciate the property's value less than \$2,500 per year,<sup>460</sup> it is possible that the borrower will make improvements substantially appreciating the value of the property without receiving any compensation for them. To avoid this inequity, a borrower should be permitted to submit estimates notwithstanding the value of the improvements. Then, upon maturity of the loan, all estimates should be accumulated.

A second shortcoming is the failure to define the term "capital improvement," making it difficult to determine whether an expenditure is a capital expenditure or a current expense. This problem is significant when the cost of certain normal items of upkeep is examined. For instance, it is not unusual to pay \$4,000 for painting the exterior of a home. If this is a capital improvement, the borrower could add the cost to the expense of the property. Over the course of a twenty- or thirty-year term, such costs could accumulate into a substantial figure.

### Title Insurance

Lenders making traditional loans normally obtain title insurance in an amount equal to the original principal of the loan. If a SAM lender obtains title insurance in the amount of the original principal, it might not be insured as to any contingent deferred interest. Assuming the lender obtains a policy in the amount of the principal loaned, a standard title insurance policy would insure a lender against loss of interest only to the extent the principal had been repaid as of the time of a claim under policy.<sup>461</sup>

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*As Amended in the Senate on August 20, 1981*, 1981-82 Reg. Sess. 5; McKenzie, *supra* note 455; Reichelt, *supra* note 7, at 41.

457. CAL. CIV. CODE § 1917.150(a) (West Supp. 1982).

458. *Id.* § 1917.150(b).

459. *Id.*

460. *See supra* note 457.

461. ALTA Loan Policy—1970 (amended 10/17/70) § 6(a); CLTA Standard Coverage Policy—1973 § 6(a). The CLTA policy form does not in any event cover "additional princi-

There are two solutions to this problem. First, the initial title insurance policy can be written for an amount larger than the original principal loan amount.<sup>462</sup> This solution has been used to a limited extent in negative amortization loans,<sup>463</sup> where title insurance companies have by endorsement insured up to 150% of the value of the secured property at the time of the loan. This form of endorsement is easily adaptable to a SAM. Currently, however, it is extremely difficult to convince title insurance companies to issue such an endorsement.<sup>464</sup>

The title insurance policy could also provide that the title insurer would supply the lender additional insurance at fixed rates subject to certain agreed exceptions.<sup>465</sup> As the property increases in value, and the lender's security interest in the property increases, additional insurance could be purchased. This solution would create administrative problems for the lender; in the residential context it would be difficult to pass the additional title insurance premiums on to the borrower. The increased use of AMIs, and the clarification of the statutory and case law relating to these types of instruments, will force title insurance companies to create special endorsements for these loans.

### The Security Instrument

The standard forms of deeds of trust and mortgages used in traditional loan transactions do not adequately protect SAM lenders. Because SAM lenders are more concerned with the condition and use of the secured property than are traditional lenders, SAMs must be more restrictive than traditional deeds of trust or mortgages.

There are several provisions SAM lenders should include in SAM

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pal indebtedness created subsequent to Date of Policy," and the ALTA policy form covers such only to the extent that the original principal has been repaid. CLTA Standard Coverage Policy—1973 § 6(a)(iii); ALTA Loan Policy—1970 (amended 10/17/70) §§ 6(a), 8(b). However, a SAM's contingent deferred interest obligation being by definition interest, and not principal, these policy exclusions are not applicable.

462. Traditionally, title insurance companies are reluctant to write policies in amounts exceeding the initial investment of the lender or owner. In a situation involving a SAM or other AMI, however, this reluctance would be ill founded.

463. THE GUARANTOR, July 1981.

464. Chicago Title Insurance Company currently has available a special endorsement for SAMs. THE GUARANTOR, May-June 1981, at 9. Also, the board of directors of the California Land Title Association is considering such measures. Currently, CLTA Endorsements 111.5 and 111.6, developed for AMIs, could be used to satisfy some of the problems of SAMs.

465. The allowable exceptions would be determined either as of the date of issuance of the original policy, or as of the date(s) of issuance of the additional insurance. Which date would be applicable would depend upon the particular title company's analysis of the lien priority question. See *supra* text accompanying notes 128-61.

security instruments. The recorded security document must include full disclosure of the SAM's contingent deferred interest provisions to protect the priority of the lender's claim to the deferred interest element.<sup>466</sup> SAM security instruments should also require the borrower to give notice to the lender of all improvements made to the premises. Some lenders may wish to extend this provision to require that the borrower seek written consent from the lender for any improvements exceeding a specific cost. SAM security instruments should also include revised foreclosure provisions. The ability of a lender to foreclose under a SAM deed of trust differs from that under a traditional mortgage, because the potential credit bid of the lender includes an amount that will be indeterminate at the time of the foreclosure sale, unless the deed of trust contains mandatory appraisal provisions relating to the contingent deferred interest element.<sup>467</sup>

Standard fire insurance provisions of the security instrument should require the borrower to maintain fire insurance in an amount equal to the value of the property. In addition, the security instrument should permit beneficiaries to inspect the secured property from time to time. Because the appreciation of the property depends on its condition, such a right could ensure that other provisions in the mortgage relating to such matters as maintenance and waste have not been violated.

Finally, SAM security instruments should permit lenders to ensure that any sale of the property by the borrower is made for a fair value. If a SAM borrower were to be permitted to establish the amount of the property's appreciation by a sale of the property, it would be possible to erode the lender's contingent deferred interest by selling the property below market value.

### Economic Questions

SAMs raise several economic questions for lenders. The first of these is how nonstatutory SAM lenders should determine the term, fixed interest rate, and share of appreciation of a particular SAM.<sup>468</sup> The commentators advise the lender to design their SAMs to ensure that lenders will "break even."<sup>469</sup> The variables of SAMs, however,

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466. See *supra* text accompanying notes 128-61.

467. See *infra* text accompanying notes 472-75.

468. Angell & Wardrep, *supra* note 231; Mylod, *supra* note 22; Reichelt, *supra* note 7; Thygeson, *supra* note 45.

469. Thygeson, *supra* note 45, at 34. "After all, the source of the contingent interest is estimated appreciation; the lender can't be expected to supply risk capital for less of a return than he would get for supplying fixed-rate debt capital." *Id.*

make this computation difficult.

SAM lenders cannot accurately predict the rate of appreciation of a particular parcel of real property. At best, an extremely short-range prediction of inflationary trends can be made. Thus, the greater the differential between the prevailing rate and a SAM's fixed rate of interest, or the longer the term of the SAM, or the larger the lender's interest in the property's appreciation, the greater the risk that the property's appreciation will not match the prevailing rate.

A second question is whether SAMs may be too volatile an investment for institutional lenders. Some critics have argued that SAMs will subject the earnings of an institutional lender to radical variations.<sup>470</sup> As a result, the long-term planning of institutional lenders will be inhibited.

Although SAMs will introduce some uncertainty into the predictive accounting procedures of institutional lenders, some estimations will be similar to current accounting procedures. All lenders must estimate the probability of increases or decreases in interest rates in assessing the value of any of their current investments. Such computations are no different than the mechanical accounting procedures necessary to carry SAMs.

The critics objecting to the variability of a SAM lender's earnings have also failed to note that any decrease in property appreciation will probably be accompanied by decreasing inflation. A drop in the inflation rate will trigger a lowering of mortgage interest rates. Thus, although a lender's return on the contingent deferred interest portion of a SAM may fall as a result of economic trends, there will likely be a corresponding drop in the cost of funds to the lender, and a corresponding drop in return on any fixed interest rate loans of that lender. Also, as inflation slows, the return on the fixed interest portion of a SAM becomes relatively more profitable. For this reason, a SAM lender's earnings should not vary radically.

SAM lenders face a third practical problem in that such loans may initially create a negative cash flow.<sup>471</sup> This results from the possible negative spread between the costs of funds to the lender and the fixed interest portion of the SAM. For instance, if the fixed interest rate of a SAM is nine percent and the cost of funds to the lender is eleven percent, an annual loss of two percent must be carried on the lender's

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470. Reichelt, *supra* note 7, at 39.

471. *Id.* at 40.

books until the contingent deferred interest is paid. The resolution of this question is, essentially, a matter of the lender's business judgment.

### Foreclosure

A fifth practical problem of SAMs involves foreclosure proceedings. The contingent deferred interest element of a SAM may complicate the ability of a SAM lender to determine the maximum amount of its credit bid at a judicial or nonjudicial foreclosure sale.

The California Civil Code permits beneficiaries under deeds of trust to make so-called "credit bids" at the time of a nonjudicial foreclosure sale.<sup>472</sup> All other bidders at a foreclosure sale may be required to show evidence of their ability to deposit with the trustee the full amount of their final bid in cash or certified check.<sup>473</sup>

A trust deed beneficiary has the right to credit bid "only to the extent of the total amount due . . . including the trustee's fees and expenses."<sup>474</sup> In a SAM, the "total amount due" will not be a sum certain. The total amount of unpaid principal and accrued interest under a SAM at any given point is equal to the sum of the unpaid principal balance plus the lender's share of the appreciated value of the secured property. Because the appreciated value of the secured property will normally be determined by either the sales price or an appraisal of the fair market value, the amount of a SAM beneficiary's credit bid will be in doubt unless the parties agree to a binding procedure to establish value.

To resolve this issue, the parties can provide in the loan documents that, if a notice of default is filed, the trustee or beneficiary may order an independent appraisal of the secured property in order to determine the amount of contingent deferred interest owing. The cost of the appraisal could be included as part of the trustee's fees and added to the beneficiary's credit bid. The appraisal must be deemed binding on trustor, beneficiary and junior lienors.

### Conclusion

A SAM is a novel financing technique, presenting a variety of legal and practical questions rarely encountered elsewhere. An understanding of these questions will enable the practitioner to avoid potential pitfalls, and allow both lawyers and laymen alike to compre-

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472. CAL. CIV. CODE § 2924h(b) (West 1974 & Supp. 1982).

473. *Id.*

474. *Id.*

hend the great flexibility as a financing tool inherent in SAMs and other AMIs. Such comprehension is vital to understanding the potential benefits of SAMs and other AMIs, whether used for residential, commercial or other property; for purchase financing, construction financing or refinancing; and whether in times of high or low inflation and interest rates.



